**Hearing on "Legislative Proposals Regarding Derivatives"**

***Protecting Financial Stability and Enhancing Competitiveness in the Derivatives Markets***

Testimony before the U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Securities and Investment

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Thank you, Chairman Huizenga and Ranking Member Maloney, for the opportunity to testify on this important topic. I am the Managing Director for Economic Policy at the Center for American Progress, where I help oversee the work of our Economic Policy team. Today, I will discuss the important reforms made to the derivatives market by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, outline views on some of the derivatives-related legislative proposals before the Subcommittee today, and suggest fruitful areas for the Subcommittee to consider going forward.

**Background on Derivatives and Past Market Failures**

The derivatives market is a vital avenue for financial and nonfinancial companies to prudently hedge the risks they face—including foreign exchange, interest rate, and credit risks. One portion of the derivatives market, namely futures and options contracts in which a buyer and seller agree to transact (or the buyer has the option to transact) at a certain price on a future date, have long been regulated and traded on public exchanges. However, a large segment of the derivatives market, consisting primarily of swaps—contracts in which counterparties agree to swap different cashflows that may reference specific indexes or interest rates—were unregulated prior to the financial crisis. These derivatives, referred to as over-the-counter (OTC) derivatives were truly left in the shadows of our financial system.

Today, the OTC derivatives market stands at roughly $550 trillion, in terms of the notional amount of outstanding contracts.[1] This massive market may not directly impact the day to day life of the average American, but a severe disruption in the market can have knock on effects impacting the real economy. As former Chairman of the Commodity Futures Trading Commission (CFTC), Gary Gensler, stated so aptly, "So many people...in the United States who never had any connection to derivatives or exotic financial contracts had their lives hurt by the risks taken by financial actors."[2] We must get the regulation and oversight of these markets right. Prior to financial crisis, we did not. And the economy, workers, and families suffered the ills of that mistake. When derivatives markets are functioning well, however, consumers experience the benefits of better prices, as financial and nonfinancial companies across the economy are able to better manage the risks they face.

The unregulated OTC derivatives market was at the heart of the 2007-2008 financial crisis, which cost 8.7 million Americans their jobs, 10 million families their homes, and eliminated 49

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[1] Bank for International Settlements, "Statistical release OTC derivatives statistics at end- June 2017" (2017) https://www.bis.org/publ/otc_hy1711.pdf

[2] Chairman Gary Gensler, "OTC Derivatives Reform," testimony before the Chatham House, London, March 18, 2010, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-35

percent of the average middle-class family's wealth compared with 2001 levels.[3] OTC derivatives tied counterparties across the financial sector together in complex webs of risk, largely out of sight of regulators. Christopher Cox, the chairman of the Securities and Exchange Commission (SEC) during the financial crisis, referred to the market as a "regulatory blackhole."[4] Then-president of the Federal Reserve Bank of New York Tim Geithner expressed similar concerns in 2006 regarding the market, including challenges in the firms' infrastructure and operational management of these contracts.[5] This market was a clear source of systemic risk. The buildup of financial sector interconnectedness meant that material financial distress at one or a handful of financial companies could quickly reverberate throughout the financial system.

For example, American International Group Inc. (AIG) had a substantial portfolio of credit default swaps (CDS) it had written against collateralized debt obligations stuffed with subprime mortgages.[6] The CDS were insurance products at their core and AIG was essentially insuring others against the risk that the subprime mortgage market would bottom out. When the subprime mortgage market did indeed crash, AIG had to payout the CDS contracts.[7] Because these derivatives were not regulated like a traditional insurance product or in any other responsible way, AIG didn't have adequate capital or reserves to cover the losses—bringing the global insurance company to the brink of failure. AIG's failure would have caused significant losses for the company's derivatives counterparties, as the default swaps were being used by AIG's

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[3] Annalyn Kurtz, "U.S. soon to recover all jobs lost in crisis," CNN Money, June 4, 2014, available at http://money.cnn.com/2014/06/04/news/economy/jobs-report-recovery/; Carmel Martin, Andy Green and Brendan Duke, eds., "Raising Wages and Rebuilding Wealth: A Roadmap for Middle-Class Economic Security" (Washington: Center for American Progress, 2016), available at https://www.americanprogress.org/issues/economy/reports/2016/09/08/143585/raising-wages-and-rebuilding-wealth/; National Center for Policy Analysis, "The 2008 Housing Crisis Displaced More Americans than the 1930s Dust Bowl," May 11, 2015, available at http://www.ncpa.org/sub/dpd/index.php?Article_ID=25643.

[4] Chairman Christopher Cox, "Speech by SEC Chairman: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System," October 8, 2008, available at https://www.sec.gov/news/speech/2008/spch100808cc.htm.

[5] Timothy F. Geithner, President of the Federal Reserve Bank of New York, "Implications of Growth in Credit Derivatives for Financial Stability," Remarks at the New York University Stern School of Business Third Credit Risk Conference, New York City, May 16, 2006, available at https://www.newyorkfed.org/newsevents/speeches/2006/gei060516.

[6] Alistair Barr, "AIG execs say super senior CDO portfolio in 'run off,'" MarketWatch, May 9, 2008, available at http://www.marketwatch.com/story/aig-execs-say-super-senior-cdo-portfolio-in-run-off.

[7] Robert McDonald and Anna Paulson, "AIG in Hindsight" (Chicago: Federal Reserve Bank of Chicago, 2014), available at https://www.chicagofed.org/~/media/publications/working-papers/2014/wp2014-07-pdf.pdf;

counterparties to hedge against a subprime market downturn.[8] The Federal Reserve bailed out AIG's in part because its failure would cause failure or distress at other financial institutions across the financial sector.[9]

AIG was by no means the only example of the dangerous webs of risk created by unregulated derivatives during the crisis. Lehman Brothers' disorderly failure, which was felt across the global financial system in September of 2008, was exacerbated due to the company's extensive OTC derivatives portfolio. The company had around 930,000 OTC derivatives contracts at the time of its failure.[10] Moreover, the systemic importance of Bear Stearns, Merrill Lynch, and countless other financial institutions that were bailed out during the crisis was increased by their OTC derivatives portfolios.[11]

The significant risks posed by unregulated derivatives markets were not necessarily new in 2007-2008. In 1998, the highly leveraged hedge fund, Long Term Capital Management (LTCM), leveraged roughly $4 billion of net assets into $125 billion in gross assets. Beyond LTCM's leveraged balance sheet, it also used OTC derivatives to increase its total leverage exposure to $1 trillion.[12] When the hedge fund's bets went sour, the Federal Reserve Bank of New York stepped in to help facilitate a private bailout of the firm because many large Wall Street banks were LTCM's counterparties.[13] Speculative derivatives losses also led to the downfall of another sizeable hedge fund, Amaranth Advisors. Amaranth lost $6 billion on unregulated energy

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[8] Serena Ng and Carrick Mollenkamp, "Goldman Fueled AIG Gambles," The Wall Street Journal, December 12, 2009, available at http://www.wsj.com/articles/SB10001424052748704201404574590453176996032.

[9] Federal Reserve Bank of New York, "Actions Related to AIG" available at https://www.newyorkfed.org/aboutthefed/aig.

[10] Michael Greenberger, "The Role of Derivatives in the Financial Crisis," Testimony before the Financial Crisis and Inquiry Commission, June 30, 2010, available at https://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-Greenberger.pdf.

[11] Board of Governors of the Federal Reserve System, "Bear Stearns, JPMorgan Chase, And Maiden Lane LLC," available at https://www.federalreserve.gov/regreform/reform-bearstearns.htm (last accessed February 2018); Gretchen Morgenson, "How the Thundering Herd Faltered and Fell," *The New York Times,* November 8, 2008, available at http://www.nytimes.com/2008/11/09/business/09magic.html.

[12] Michael Fleming and Weiling Liu, "Near Failure of Long-Term Capital Management," Federal Reserve Bank of Richmond, November 22, 2013, available at https://www.federalreservehistory.org/essays/ltcm_near_failure.

[13] Roger Lowenstein, "Long-Term Capital Management: It's a short-term memory," The New York Times, September 7, 2008, available at http://www.nytimes.com/2008/09/07/business/worldbusiness/07iht-07ltcm.15941880.html.

derivatives when its bets in the natural gas market went south.[14] Additionally, unregulated energy derivatives were at the center of Enron's collapse. The company looked more like a financial institution than a utility company by the time of its demise.[15] Enron used OTC derivatives to hide debt, to hide losses, and to speculate.[16] When its smoke and mirrors risk-shifting and highly-leveraged speculation came crashing down, the $63 billion energy giant filed for bankruptcy—at that time the largest bankruptcy filing in U.S. history.[17] Unfortunately following these episodes, which revealed the dangers of unregulated derivative markets, no material improvements were made to the regulatory regime—paving the way for the central role played by the OTC derivatives market in 2007-2008.

In addition to increasing the interconnectedness of the financial sector, OTC derivatives enabled financial companies to conceal their leverage prior to the 2007-2008 crisis. These unregulated markets did not have adequate capital or margin requirements for derivatives held by banks, or any capital/margin requirements for non-bank dealers, which would have restricted the leverage employed by institutions using these financial instruments. On-balance-sheet leverage, funding assets through various forms of borrowing, was restricted—albeit inadequately—at the firm-level by capital requirements. Similarly, regulated derivatives markets, through exchange trading and clearing, required counterparties to put up capital at the transaction-level known as margin, to protect against counterparty default. Not having adequate capital or margin requirements in place in the OTC derivatives markets enabled firms to take on excessive leverage, without adequate buffers to protect against price movements against their positions.

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[14] United States Senate Permanent Subcommittee on Investigations, "Excessive Speculation in the Natural Gas Market," Staff Report, June 2007, available at https://www.hsgac.senate.gov/download/report-psi-staff-report-excessive-speculation-in-the-natural-gas-market-6/25/07; Jenny Anderson, "Betting the House and Losing Big," *The New York Times*, September 23, 2006, available at http://www.nytimes.com/2006/09/23/business/23hedge.html?mtrref=www.google.com.

[15] Michael Schroeder, "Enron's Dealing in Derivatives Helps Shift Spotlight to a Gap in Oversight," The Wall Street Journal, January 28, 2002, available at https://www.wsj.com/articles/SB1012168575563404120; Frank Partnoy, "Testimony of Frank Partnoy before the Unites States Senate Committee on Governmental Affairs," January 24, 2002, available at https://www.hsgac.senate.gov/download/?id=e61872aa-e5b1-4f41-a184-d4ebab8faa46.

[16] Ibid.

[17] The Associate Press, "Enron Will Emerge From Bankruptcy Protection," The New York Times, July 16, 2004, available at http://www.nytimes.com/2004/07/16/business/enron-will-emerge-from-bankruptcy-protection.html.

In addition to the systemic risk arising from the unrestricted leverage and interconnectedness of the OTC market, certain OTC derivatives products were used speculatively and magnified risk, instead of hedging it. The bipartisan report of the Senate Permanent Subcommittee on Investigations, among others, chronicled how credit default swaps enabled the creation of synthetic (otherwise non-existent) exposures to subprime mortgages, which in turn dramatically expanded the financial sector's exposure to those assets.[18] These products did not serve to manage or hedge against risks, but simply enabled speculative activities and increased the buildup of excessive risk in the financial system.

Following the 2007-2008 financial crisis, policymakers understood the need to bring the OTC derivatives market out of the shadows to regulate and oversee the complex maze of interconnections that had built up over time.

**Title VII Reforms Enhance Market Stability and Competitiveness**

In the wake of the devastation wrought by the financial crisis, Congress and the Obama administration took action to reform the financial regulatory regime in the U.S. and passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Title VII of Dodd-Frank addressed the significant flaws in the unregulated OTC derivatives market that proved so costly during the crisis. The bill mandated a series of regulatory improvements to the swaps markets, including: (i) registration requirements for swap dealers and major swap participants; (ii) requirements that standardized OTC derivatives be centrally cleared through clearinghouses; (ii) requirements that trading of standardized OTC derivatives take place on exchange-like platforms; (iii) new capital requirements for swap dealers and major swap participants and margin requirements for uncleared swaps; (iv) data reporting and recordkeeping requirements; (v) governance requirements and protections against conflicts of interest for the users of these products; and (vi) position limits to limit speculative activities; among others. The bill directed the CFTC for most swaps and the SEC for security-based swaps to promulgate implementing

[18] HSGAC Subcommittee on Investigations, "Senate Investigations Subcommittee Releases Levin-Coburn Report On the Financial Crisis," Press release April 13, 2011, available at https://www.hsgac.senate.gov/subcommittees/investigations/media/senate-investigations-subcommittee-releases-levin-coburn-report-on-the-financial-crisis.

rules and also strengthened enforcement tools at both agencies. It also clarified, mandated, and strengthened robust cross-border coverage, owing to the fact that risks in swaps can easily flow back to the United States.

The goal of these reforms was to bring stability, transparency, and competition to this previously-unregulated segment of the derivatives market. In several respects, these policy ideas were not novel—variations of many of them had worked for decades (or longer) in the regulated segment of the market. The registration, reporting, and recordkeeping requirements all were meant to provide regulators and market participants with greater insight into the day-today functioning and structure of the OTC derivatives market. The central clearing mandate was included to address the dizzyingly complex, and systemically risky, interconnections created by the web of OTC derivatives transactions across the financial sector—ensuring that a dedicated third party assumed, managed, and reduced the resulting counterparty risks. The goal of exchange-like trading mechanisms was to improve the liquidity, pre-trade transparency, and costs for end-users, as the old off-exchange trading processes were cumbersome and opaque. Capital and margin requirements were a must to improve the resiliency of these markets to face the systemic risks they create. Governance requirements better protected end-users from abuses. And position limits help further these goals by restricting the negative impact that excessive speculative activities can have on real economy users of physical commodities.

Nearly eight years have passed since Dodd-Frank passed Congress and was signed into law by President Obama. Beyond sounding well-meaning in theory, have these changes in practice addressed the pre-crisis ills of this market? We can answer that question with a resounding yes: significant progress has been made. Central clearing of OTC transactions has increased significantly since the crisis. In 2007, roughly 15% of derivatives overseen by the CFTC were centrally cleared.[19] Today, the dollar volume of cleared swaps is north of 80%.[20] Research in the CDS market shows that the increase in the use of central clearing has reduced counterparty credit

[19] Chairman Timothy G. Massad, Testimony before the U.S. Senate Comittee on Agriculture, Nutrition & Forestry, May 14, 2014, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-22.

[20] U.S Commodity Futures Trading Commission, "Swaps Reports Archive," available at http://www.cftc.gov/MarketReports/SwapsReports/Archive/index.htm, December 29-January26 dollar volume of IRS and CDS (cleared/total).

risk, and has improved liquidity in the market.[21] Moreover, the use of exchange-like entities known as swaps execution facilities (SEFs) has improved pre-trade transparency for end-users and increased competition in the market. End-users can compare prices in real-time and analyze competing bid/offers from multiple dealers. The Bank of England analyzed the impact of SEFs on the OTC derivatives market and found that in the U.S., "total execution costs for end-users are reduced by about $7-$13 million a day" for SEF mandated swaps.[22]

While the CFTC and the prudential regulators have largely completed implementing their parts of the Title VII regime, the SEC has, unfortunately, little to show for its efforts to implement its securities-based swaps mandate. By deferring the effectiveness of its rules until all of them are completed, the SEC has remained frozen on even its most foundational steps.[23]

**Evaluating the Subcommittee's Legislative Proposals**

As outlined above, failures of the unregulated derivatives markets had enormous negative impacts on financial stability, which in 2008 contributed enormously to a financial crisis that devastated U.S. economic growth and ordinary household economic performance. Moreover, the sensible reforms put in place following the crisis have, by all available evidence, begun to succeed as intended to reduce the risks to the U.S. economy and taxpayers from failures in the derivatives markets, as well as lower costs for the users of those financial markets by increasing transparency and enhancing competition. Firms have already made investments in updating their business operations and compliance systems. As such, any legislative proposal should have to overcome a heavy burden in favor of maintaining what is working.

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[21] Yee Cheng Loon and Zhaodong Zhong, "Does Dodd-Frank Affect OTC Transaction Costs and Liquidity? Evidence from Real-Time CDS Trade Reports," *Journal of Financial Economics (JFE),* Forthcoming (2015), available at http://bit.ly/2E9n5t4.

[22] Evangelos Benos, Richard Payne and Michalis Vasios, "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act" Working Paper 580 (Bank of England, 2015), available at https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2016/centralized-trading-transparency-and-interest-rate-swap-market-liquidity.pdf?la=en&hash=F19D254DDF6F4AFED1D47842B65BE72170253391.

[23] U.S Securities and Exchange Commission, "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," available at https://www.sec.gov/spotlight/dodd-frank.shtml# (last accessed February 2018).

In addition, financial regulatory reform proposals need to be considered on the whole. Derivatives reforms designed to enhance stability across the derivatives markets are importantly complemented by the designation process put in place under the Financial Stability Oversight Council (FSOC), which looks at the risks present in nonbank financial firms that could, if not properly regulated, create knock-on effects even across otherwise well-regulated systems. Similarly, the Office of Financial Research (OFR) was deployed to look across the financial system to identify the build-up of unexpected and problematic risks. Today, however, FSOC appears to be in the process of undoing much of its designation process, while OFR in 2017 suffered a 25 percent budget cut from 2016 and remains under funding and other pressures.[24] It is unclear what the Federal Reserve Board, under its new leadership, and other regulators will do on other important reforms, such as higher capital, stronger liquidity, and the Volcker Rule's requirements that banking organizations focus on serving clients and the real economy. But the overall direction as outlined by the Treasury Department's series of reports points towards highly troubling levels of deregulation. Those are wrong on their own, but they also matter to how the derivatives markets function, as those markets magnify and transmit risks across financial institutions and markets. To the extent that institution-based oversight is being dialed back, it places even more strain on any weaknesses that may emerge in the derivatives markets. Policymakers must keep as a top priority ensuring that derivatives markets have sufficient firewalls to stop a future financial conflagration from spreading.

The series of bills presented for consideration in today's hearing all appear to press in the wrong direction. The degree of severity depends upon the bill. But all of them slice, dice, or otherwise poke holes – sometimes large holes – in the firewalls placed in the derivatives markets by post-2008 reforms.

A persistent theme in the bills is to extend the scope of commercial end-user treatment to entities and activities that are financial in nature. As discussed in greater detail below, this violates the basic bargain that strong regulatory protections are put in place across the market, which is

[24] Gregg Gelzinis, "The Trump Administration Is Quietly Slashing Financial Stability Funding," (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/news/2017/12/07/443709/trump-administration-quietly-slashing-financial-stability-funding/.

dominated by financial firms, and that special treatment can be accorded the relatively small number of commercial entities.[25] To draw an analogy to public health, a small number of people can avoid being immunized and still remain protected by the broader use of a vaccine, but if that group becomes too large, everyone is put at risk – especially those people who actually cannot be immunized.

To the extent that any of the bills embody specific concerns by market participants, far more needs to be done to study these specifically identified challenges. To facilitate ensure accurate analyses and broad-based consensus on these questions, far more market and institutional data must be made available to, and usable by, the public. Right now, even regulators struggle to digest the mountains of inconsistent and messy data coming in from swap data repositories. Data challenges exemplify the importance of new institutional resources like OFR, which has been helping the chronically underfunded CFTC to improve swaps data and more broadly had been working internationally to establish new data standards like the Legal Entity Identifier (LEI) as well as swaps-specific identifiers like a unique product identifier and a unique transaction identifier. These efforts are key to identifying and potentially stopping both major market disruptions and abuses. For example, the inability of market participants and regulators to understand exactly which firms were responsible for which trades created a significant risk that exacerbated the 2008 financial crisis. [26] Further, the failure to have LEIs in our trading system makes it extremely difficult for regulators to identify and police potential abuses.[27] These efforts are essential for proper modern financial system oversight.

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[25] It is worth noting that the special treatment accorded to commercial end-users, such as using uncleared swaps or not posting margin, largely involves extensions of credit by the swap dealer to the end-user. Given the impacts that high levels of corporate indebtedness can have on investors and financial stability, whether these extensions of credit are properly collateralized from a risk perspective, recognized from credit rating and debt covenants perspective, and collectively examined from a systemic risk perspective are themselves questions worth examining more closely, especially in a rising interest rate environment.

[26] Tyler Gellasch, Executive Director, Healthy Markets Association before the House Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment, "Implementation and Cybersecurity Protocols of the Consolidated Audit Trail", Nov. 30, 2017, available at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-tgellasch-20171130.pdf.

[27] Ibid.

Similarly, markets need more information about the swaps exposures and activities, especially at the subsidiary level, of the largest institutional participants in the markets. The SEC has been engaged in a "Disclosure Effectiveness Review" and has also invited comment on updating its guide setting standards on financial institution disclosure. Enhancing disclosure will both better protect investors in financial institutions and others active in the derivatives markets, but also improve the ability for policymakers, academics, and the public to evaluate the successes and areas for improvement in the derivatives markets.

Lastly, policymakers should avoid falling victim to the argument that reducing regulation will enhance competition and benefit ultimate end-users and the real economy. Financial markets have a strong frequent tendency towards rent-seeking behavior which comes at the expense of the real economy. Regulatory standards are required to ensure transparency and competition that will benefit those in the real economy that would utilize those markets, irrespective of financial stability purposes. Small and mid-sized businesses, family farmers, and others in the real economy are far better served by a simple, robustly regulated market where prices are transparent and competition is meaningful.

Below are specific comments on the proposals.

*H.R. 4659, To require the appropriate Federal banking agencies to recognize the exposure-reducing nature of client margin for cleared derivatives.*

This bill directs the federal prudential banking regulators to revise leverage capital requirements by deducting initial margin provided by a client against a centrally-cleared derivative from the denominator of the leverage ratio. If enacted, H.R. 4659 would chip away at the Supplementary Leverage Ratio (SLR), an important post-crisis capital requirement that applies to the largest banks in the U.S.[28]

[28] Board of Governors of the Federal Reserve System, "Agencies adopt supplementary leverage ratio final rule," Press release, September 3, 2014, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140903b.htm.

The SLR is meant to serve as a risk-blind complement to risk-weighted capital requirements, protecting against the possibility that risk-sensitive requirements, including actions that in theory are risk-mitigating, are improperly calibrated.[29] For example, mortgage-backed securities received low risk-weights in advance of the last crisis—one of the many reasons banks were highly undercapitalized to handle the risks they took. The two types of capital requirements work in tandem to ensure the largest banks have appropriate capital buffers to remain resilient and serve the real economy throughout the economic cycle. Deducting the initial margin held against centrally cleared derivatives from the SLR denominator would undermine the essential simplicity of the leverage ratio.

Moreover, as FDIC Vice Chairman Tom Hoenig has pointed out, when dealer banks provide a full guarantee to the clearinghouse for cleared swaps, they have a potentially unlimited loss exposure. As such, deducting collected margin, which is only the very first line of defense from those losses, makes no logical sense because capital is precisely designed to provide a cushion against *unexpected* losses. For the same reason, collateral, such as against loans, does not reduce the SLR calculation denominator in other contexts.[30] It is also unclear as to how Trump-appointed regulators may further change additional rules in this deregulatory environment. Proponents of H.R. 4659 point to the regulations against rehypothecation for segregated client margin as an important protection, but those rules may change. Using rules that may change to justify statutory changes is not wise.

Moreover, this proposed change would have the net effect of lowering the amount of equity capital with which the largest banks in the U.S. fund themselves. With bank capital requirements for the largest banks already below the socially optimal levels, no actions should be taken to deplete their loss absorbing equity buffers.[31] Unfortunately, this proposal is only one prong of the

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[29] Gregg Gelzinis, "3 Flawes Banking Industry Arguments Against a Key Postcrisis Capital Requirement," (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/news/2017/10/27/441413/3-flawed-banking-industry-arguments-against-a-key-postcrisis-capital-requirement/.

[30] FDIC Vice Chairman Thomas Hoenig, Letter to Chairman Conway and Ranking Member Peterson on margin and leverage, November 30, 2015, available at https://www.fdic.gov/about/learn/board/hoenig/hoenigletter11-30.15.pdf.

[31] Gregg Gelzinis, Andy Green, and Marc Jarsulic, "Resisting Financial Deregulation," (Washington: Center for American Progress, 2017), available at

efforts underway to undermine the SLR, which would be a significant mistake for those who care about ensuring the financial system can effectively serve the real economy and promote economic growth throughout the macroeconomic cycle.

*H.R._____, To direct the Securities and Exchange Commission and Commodity Futures Trading Commission to review and harmonize rules relating to the regulation of over-the-counter swaps. (DERIV_001)*

This bill would require the CFTC and SEC to review all of its rules and where any "inconsistencies" are found to immediately institute a *joint* rulemaking to harmonize the differences. Unfortunately, this bill masquerades as good government but is in reality a recipe for deregulation and regulatory gridlock. Moreover, it fundamentally ignores the genuine differences between the markets that the SEC and CFTC regulate, as well as the different authorities and traditions that the agencies and others bring to the regulation of the product markets underlying the derivatives. While similar regulatory approaches often make sense, there are also many instances where good public policy demands that rules be different because the markets are different.

Swaps as derivatives perform different based on the underlying nature of the product market being referenced. Interest rates, currencies, commodities, bonds (credit), and equities each behave – and are regulated – very differently from each other. Differences even exist between index markets and single-name markets. Yet, rules that have been tailored for relevant markets would have to be untailored?

To draw an analogy, this would be like saying that cars, trains, buses, and airplanes all need to have the same travel safety rules. Some similarities exist, meaningful differences do too, in part because they have different physical characteristics, travel at different speeds, etc.

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https://www.americanprogress.org/issues/economy/reports/2017/12/04/443611/resisting-financial-deregulation/.

A far better approach is to continue to encourage the staffs of the two agencies to coordinate and communicate so that they can properly tailor their regulations to work best for the markets they regulate.

H.R._____, *To amend the Dodd-Frank Wall Street Reform and Consumer Protection Act to establish an exemption from the credit valuation adjustment calculation for uncleared derivatives transactions with end-users so that United States companies are not disadvantaged, and for other purposes. (DERIV_002)*

This bill would eliminate capital buffers mandated to protect financial institutions from the risk of loss from default by end-users. The argument being asserted is that Europe does not require it, so the U.S. should not, ostensibly on the grounds of international competitiveness. These arguments, however, are flawed, and capital should not be lowered simply because an end-user is in play.

Would anyone on this committee suggest that when a bank makes a loan to an ordinary "end-user" business, that it should not retain an appropriate capital buffer to protect itself against the risk of default by the borrower? When a dealer engages in a swap with a counterparty and does not require the collection of margin, the dealer has essentially combined a swap and a loan for the amount of the uncollected margin. Capital is the <u>bare minimum</u> risk protection for the financial system needed in that circumstance, and the CVA (via fair value) tailors that to the actual market risk created by the swap – which itself is valued on a fair value basis and can move significantly from day to day.

As an aside, it should be remembered that capital does not replace margin. During the financial crisis, dealers made increasingly widespread margin calls against counterparties as the swaps were moving against the counterparties on a daily basis. This created significant financial distress on the counterparties, ultimately leading to the widespread necessity for bailouts and extraordinary financial intervention by the central bank and the taxpayers. Capital would have better enabled dealers to withstand defaults and losses, but it would not have fully addressed the margin calls across the system.

Nor is international competitiveness really at issue here. European banks have long been undercapitalized, in part because European countries have a much greater tradition of bailing out both their banks and their end-user industrial companies. To the contrary, strong capital has long been a source of competitive strength, and of course taxpayer protections, for U.S. banks. As credit rating agencies increasingly recognize this, it will be increasingly difficult for European banks to sustain their derivatives competitiveness – which very much depends on credit worthiness of the dealer – in the face of U.S. capital strength. In any case, U.S. taxpayers will not be asked to rescue European counterparties and should not be asked to rescue U.S. banks for defaulted swaps exposures by European businesses. To that end, American regulators should not be pressed to follow European approaches that do not work here in the United States.

Furthermore, this proposal would also reduce competition in the market overall. As swaps depend on creditworthiness, to the extent that firms can improperly rely on their position in the Federal safety net to extend under-capitalized swaps to counterparties, other competitors will be challenged to compete.

*H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to remove unfairness in the scope of end-user relief for end users hedging bona fide business risks, and for other purposes. (DERIV_003)*

This bill would first extend "end-user" exemptions from swaps clearing provisions of Title VII to a new range of financial firms, including unregistered commodity pools (the CFTC equivalent of a private fund) and to private funds invested in physical assets, which would appear to include real estate, or engaged in owning commercial businesses, such as private equity funds. As a matter of principle, this would breach the wall separating commercial end-users that can enjoy a clearing exemption, from financial firms that should partake in the standard regulatory practices mandated for the derivatives market. The principle behind extending this relaxed regulatory treatment to commercial end-users is that these non-financial, "real economy" companies were both a small part of the market and not otherwise engaged in financial activities such that extending financial regulation to them was seen as inappropriate.

Putting aside the fact that even the commercial end-user exemption itself rests on shaky conceptual and risk-mitigation grounds,[32] this bill would extend those end-user exemptions to an as-yet-unclear, but potentially very large, array of financial actors (real estate funds, private equity funds, and private commodity pools). When more of the market is not subject to clearing, more of the risk is concentrated in the large dealer banks.

Moreover, the funds being considered in this bill are otherwise precisely in the business of providing services and making investments in the financial markets. Indeed, real estate (and not just mortgages) has long been a significant source of bubbles and busts in the financial system, including as recently as 2008.[33] From both a risk and "sympathy" perspective, there is no justification for this potentially large extension of the clearing exemption.

Second, the bill would create a new "de minimis" amount of non-hedging swaps activities – $1 billion notional average daily volume – for certain financial entities. This appears to be principally focused on financial units of non-financial firms. As such, it would appear to permit non-financial companies through their central treasury units (CTUs) or other financial special purpose vehicle affiliates to enjoy the end-user exemption not just to hedge the risk of its commercial affiliates but also to operate as a hedge fund speculating in the markets. Moreover, a $1 billion notional average daily volume is enormous for every market other than interest rates. As such, it would operate a large-scale deregulation of nearly every swaps markets other than interest rates. Such an approach would undermine the financial stability of the derivatives markets, be a significant investor protection problem, and be highly anti-competitive for other companies operating in those real economy markets.

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[32] A commercial end-user subject to a clearing requirement would still be serviced by a dealer bank, which would simply act as its agent for clearing and extend a line of credit to the end-user for the purposes of satisfying margin requirements. The end-user would be better protected from the failure of the dealer than in the current environment.

[33] Marc Jarsulic, *Anatomy of a Financial Crisis: A Real Estate Bubble, Runaway Credit Markets, and Regulatory Failure*, (Palgrave Macmillan US, 2010).

As noted elsewhere in this testimony, Title VII regulation was designed to extend the stability-enhancing benefits of regulation, such as clearing, margin, and pre- and post-trade transparency, as widely as possible and in particular to all financial participants in the swaps markets. Genuine non-financial businesses seeking to hedge their commercial risks have long been accorded special treatment, both on the grounds that they were not engaged in financial businesses and on the grounds that their footprint in the swaps market was small. Remember, by not requiring clearing or margin, the U.S. taxpayer is essentially encouraging the largest bank dealers to extend an uncollateralized loan to end-users in addition to the ordinary risks of the swap.

But this bill's so-called "de minimis" approach to speculative swaps of financial units of certain firms would violate both justifications for "end-user" treatment. The amount of swaps that would now enjoy "end-user" treatment could be quite large. And because it is not based on the principle of actually supporting the real economy, it fails on the public policy principle that Dodd-Frank has used to justify the increased threat to financial stability and U.S. economic growth that comes from the special regulatory treatment.

The proposed approach also undermines investor protection, worker protections, and competitiveness. By facilitating a greater amount of speculation in the treasury units of large corporations, investors and workers face a greater risk that the firm will collapse from its swaps activities. The history of prominent companies that saw large losses from swaps speculation in the 1990s shows that investors, especially retail investors and longer-term pension and mutual fund investors, are not well-equipped to judge the risks from swaps in large commercial companies. And with the dominance of today's passive index funds, they may not have much choice. Workers too make their "investment" of working at companies based on the reliability and future prospects of its operating business, and not its financial speculation units. The U.S. has long sought to ensure that financial speculation remains in speculative investment vehicles. When it has let those separations collapse, the results have been highly problematic.

Lastly, increased financial speculation by larger swaps parties poses competitiveness challenges to smaller firms. Swaps markets are highly dependent upon good credit ratings, which generally accrue to larger firms. A larger firm in a market may be able to use its size to engage in swaps

trading to juice its returns, which its smaller competitors may not be able to do. Magnifying this trend will simply serve to solidify the dominance of larger firms in markets, and amplify the growing problem of monopoly across the U.S. economy. For those concerned with smaller energy and commodity companies, including farmers, this bill should be particularly worrying.

*H.R.______, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to clarify the relief from mandatory clearing available to centralized treasury units of nonfinancial affiliates, and for other purposes. (DERIV_004)*

This bill is claimed to be a technical amendment to a revision to Dodd-Frank passed in 2015 that permitted central treasury units (CTUs) of non-financial end-users to be fully treated as end-users themselves and so qualify for an exemption from mandatory clearing under Title VII. However, it undermines the simple and straightforward approach that both Congress and the CFTC have taken to the treatment of CTUs by permitting a much broader web of swaps within the end-user. In particular, it eliminates the firewall between the end-user's commercial activities and the end-user's financial entity activities.

It should be remembered, that Dodd-Frank left in place the fact that some commercial end-users have affiliates engaged in financial activities, often in the form of specialized lending and related hedging with derivatives, to support the sales of their products or otherwise manage the risks of inputs to their products. The CTU exemption attempted to ensure that the end-user exemption remained on the true commercial end-user side, and not mingle the financial activities of the firm, which should not enjoy end-user treatment. Opening up co-mingling between commercial and financial entity activities, even if not directly trading with the CTU, undermines the simplicity and enforceability of a limited CTU provision and should not be adopted.[34]

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[34] It has been asserted that some end-users are unable to utilize the 2015 CTU changes to Dodd-Frank owing to a quirk in their operations. These companies maintain affiliates located in foreign jurisdictions, such as in China, that are firewalled from the other operations of the firm, including CTU, because the foreign jurisdiction does not permit the free convertibility of its currency. In this firewall, at least as it exists today, all capital must be paid into the firewalled country and cannot be removed without foreign regulatory approval. Because of this firewall, the firm will also establish a special purpose vehicle (SPV) to make loans to support the firm's commercial business in China. Because the China-based commercial affiliate may enter into a swap with the China-based SPV, a financial entity, the entire organization could be seen to lose the CTU exemption.

*H.R.____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to exempt swap transactions between affiliated entities from the swaps rules issued by the Securities and Exchange Commission and Commodity Futures Trading Commission. (DERIV_005(2))*

This bill is an extraordinarily broad and dangerous bill that would appear to exclude from swaps regulation all interaffiliate swaps. The bill itself reveals just how unwise that is, as it attempts to write back in certain aspects of swaps regulation such as risk management, reporting, and variation margin. Yet by eliminating the swaps regulatory authority and jurisdiction for oversight – and hence the CFTC and SEC's ability to monitor these swaps – the bill still amounts to a near complete deregulation of this critical segment of swaps. Importantly, the bill would appear to exempt uncleared interaffiliate swaps from capital requirements as well.

Appropriate oversight of interaffiliate swaps is important for a number of reasons, including ensuring market confidence in the funding stability of important financial subsidiaries, ensuring sufficient risk buffers between them, and protecting the U.S. affiliates from weak practices overseas. While some degree of tailoring may be appropriate for these types of swaps, a complete exemption from treatment as a swap is unacceptable. As discussed below, making publicly available more data about subsidiaries' swaps exposures would be helpful to a thoughtful dialogue.

*H.R.____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to align margin and clearing requirements by clarifying the definition of "financial entity", and for other purposes. (DERIV_006)*

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Without evaluating the scope or veracity of the circumstance just described, nor the regulatory or commercial wisdom of the swap between the two China-based entities, to the extent this circumstance truly is the central challenge being met by this bill, it is far narrower than how the bill is drafted. Should policymakers wish to address the specific challenge noted above, a recommended approach would be to request a CFTC study and public report on the existence and necessity of addressing the problem and what options offer targeted solutions.

This bill claims to align the margin and clearing definitions, but it has no apparent purpose or clearly defined beneficiary and would insert enormous uncertainty and potentially vast loopholes into the law. One reading of the bill offers a rather absurd possibility whereby swaps dealers would be able to take advantage of the “end-user” clearing exemption because the “notwithstanding” clause does not clearly cure the exclusion of swaps dealers from the definition of financial end-user. Assuming that is not the sponsor’s intent, is the bill really designed simply to exempt sovereign entities and multilateral lending institutions from clearing? If so, then the bill should clearly and simply state those entities. But even then care needs to be taken that state-owned enterprises not be covered.

More troubling is the possibility that the bill opens up a gap between the two definitions for the purposes of reducing the clearing requirement for some segment of financial entities or firms otherwise engaged in financial activities otherwise captured by the financial entity definition. Possibilities could include payments system companies, including potentially credit card processors and virtual currency platforms. Until further clarity is provided around the purpose and scope of the bill, given its dangerous drafting, it should not be advanced.

*H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to encourage risk mitigation by excluding all hedging swaps from the swap dealer de minimis threshold, and for other purposes. (DERIV_007)*

This bill is an extraordinary exercise in irresponsible policymaking. It would exclude from the *de minimis* swaps calculation used to trigger swap dealer registration any swaps that the entity trades to hedge commercial risk, including risks arising out of the entity’s or its affiliates’ swaps dealing activities.

First, it has such a broad sweep as potentially to eliminate swaps regulation for even some of the very largest dealers. We know, for example, that dealers already net their books such that gross exposures of upwards of *$90 trillion in swaps* for some of the largest bank dealers can be netted down to the range of $90 billion, simply by looking at offsetting trades. It seems not hard to imagine swap dealers claiming that this $90 billion could be further reduced – perhaps by up to

the same multiple as the gross to net exposure reduction – by claiming that many of its swaps trades were actually hedging its other swaps trades. For this reason, dealer registration rules permit only a very narrow amount of hedging to count as truly risk eliminating, and hence not part of the dealer registration threshold calculation. It specifically does not include such wide ranging concepts like "portfolio hedging," which has been credited with allowing problems such as the London Whale to arise.[35]

But at a deeper, conceptual level, the bill ignores the most basic risks that swap dealers face and why dealer (and major swap participant) regulation is in place to prevent widespread failures rippling across the financial markets. At its most fundamental, those with large swap positions, like dealers, face two risks that could lead to their collapse: 1) that the swaps they wrote will require them to pay out, in liquid assets, large sums of money, and 2) that others default on payments under swaps contracts owed *to* them. Under the first prong, firms manage those risks through keeping a supply of liquid assets on hand (liquidity) and also write "hedging" swaps to hopefully ensure that in a circumstance when they have to pay out another firm will also have to pay them. But a hedge is seldom a perfect match even just for the market exposure of the swap being created. Model failures or even simply the gap between standardized and customized swap exposures mean that what may be viewed as a "hedge" for the purposes of somewhat reducing risk on a trading desk may be very different from what represents a more fully reliable hedge, such as that which is required under CFTC's bona fide hedging rules let alone hedge accounting principles.

Moreover, the aforementioned situation is still focused on the performance of the swap itself in the market, not the credit risk of the counterparty that may not be able to make payment. To that point, because of the credit risk that the *second* firm might default, even while the dealer owes payment to another party, a hedge does not eliminate risk but in fact can increase it. In severe

[35] Arwin G. Zeissler, Daisuke Ikeda, and Andrew Metrick, "JPMorgan Chase London Whale A: Risky Business," Yale Program on Financial Stability Case Study, December 1, 2014, available at http://som.yale.edu/sites/default/files/files/2014-2A-V1%20JPMorganChaseLondon%20WhaleA-RiskyBusiness.pdf; Commodity Futures Trading Commission, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant",* 17 CFR Part 240, 77 FR 30595.

circumstances, a failure of a hedge can leave a firm confronting both ways that a firm can be forced into bankruptcy: a) because the firm may be unable to pay its bills as they come due (illiquidity) and b) because the value of the firm's liabilities exceed its assets (because the swaps payments owed them, which are assets, lose value from the default) (insolvency). Precisely because large swaps exposures can give rise to quick and sharp risk of bankruptcy for a firm, swap dealer regulation minimizes the extent to which why the firm has entered into its swaps positions matters for the calculation. This bill dramatically expands what is currently in place – which itself has conceptual weaknesses – and creates a dangerous loophole that could potentially swallow enormous amounts of, if not all, of swaps regulation.

And indeed, the history of past financial crises is replete with instances where precisely these types of problems have emerged. In the 2008 financial crisis, swap dealer firms found that their hedges were only as reliable as the creditworthiness of their counterparties. For example, AIG was bailed out in no small part to ensure it could make large payments to its swap dealer counterparties, including the most prominent U.S. and foreign financial institutions, so that they could make payments to other firms if and when called upon. In the collapse and bailout of Long-Term Capital Management (LTCM) in 1998, LTCM found that its positions, which were supposedly hedged, were actually not hedged but were instead large, leveraged bets on declining volatility. When volatility emerged unexpectedly in the market – does this sound familiar? – its positions collapsed. The Federal Reserve Bank of New York led a private market bailout of LTCM to ensure that its positions could be wound down in an orderly way. Had that not happened, other large financial institutions that had positions in the fund, counterparty exposures to fund through swaps trades, and also were making the same directional bets as the fund were at risk of both of the risks described above.

In short, a hedge can quickly become a wedge. Swap dealer regulation helps ensure a) that a firm engaged in swaps activities has sufficient capital, liquidity, risk management, and other tools in place to weather the ups and downs that markets bring and b) that any risk of one firm's failure is minimized to others in the market by maximizing the amount of swaps cleared through central counterparties, among other regulatory protections to ensure markets are resilient for the manufacturers, airlines, farmers, and others that need the derivatives markets to function reliably.

*H.R.____, To provide clarity regarding the de minimis exception annual thresholds for swap dealers and security-based swap dealers, and for other purposes. (DERIV_008(2))*

This bill would stop the CFTC from setting in motion the already-in-regulation provision that would lower the amount of *de minimis* swaps activity (that can be engaged in without triggering swaps entity registration) from the current $8 billion aggregate, 12-month gross notional amount, down to $3 billion. For the SEC's markets, it would freeze the de minimis at $400 million annually in security-based swaps.

Swap dealer registration is vitally important for market integrity: registration and regulation are there to *protect* the end-users and other participants in the markets. Clearing, margin, governance rules, and other regulations that depend upon dealer registration, as well as the direct oversight and accountability that comes with registration, provide vital protections for the farmers, ranchers, manufacturers, airlines, and others that depend on these markets. Just because a market is small does not mean that it is not very important for these companies and Main Street users. And where a market is small, smaller dealers can have a larger impact on the market's participants. Without registration and regulation, these smaller markets can be unstable, with end-users unprotected from the risks both of default and abuses by major players.

And as the evidence increasingly shows, swaps regulation enhances competition and brings *down* costs for end-users. A policy that exempts from registration a small number of politically favored firms does a disservice to everyone else.

Strikingly, by treating CFTC and SEC markets differently, the bill reveals its own fundamental conceptual flaw: swaps markets are extraordinarily different based on the underlying asset being traded. The interest rate swaps market is enormous, while the market for many commodity swaps is quite small. Currency, equity, and credit default swaps depend on the particular currency, equity, or bond (or index) being referenced. The CFTC itself recognized these differences when it tailored its block trade rules according to different markets. Consider what $8 billion

represents in terms of a large or block trade size for each asset class, selecting a few representative examples from the markets and applying the CFTC's block trade thresholds:

- About 7 large interest rate swaps of a 3 to 6 month maturity;
- About 67 large investment-grade credit default index swaps of a four to six year maturity;
- About 427 large foreign exchange swaps for USD/EUR swaps; or
- About 2,666 large commodity swaps ($60 million for WTI Crude Oil)).[36]

Ultimately, the current approach at the CFTC of an untailored *de minimis* threshold for dealer registration is problematic. For example, only two firms have had to register as swap dealers in the energy markets. This is not to say that registration should vary based on every single underlying. But some additional tailoring, similar to the approach to block trades, makes sense. Where only a small minority of dealing activity is captured by swap dealer regulation, this encourages a race to the bottom among dealers in an asset class, disadvantaging those that have implemented risk management and governance controls as required by Dodd-Frank.

*H.R._____, To clarify the definition of "financial end user" as it applies to parent and holding companies. (DERIV_009)*

The bill is somewhat opaque as to its true purposes. This bill could be designed to address the situation whereby the margin calculation across multiple affiliates sweeps in the parent company for certain margin posting requirements owing to its material swaps exposure. As a first order matter, it is far from clear that reducing the margin posting requirements of parties with large swaps exposure is a wise matter from a policy perspective. But even if so, a far narrower and constrained drafting approach, one that retains regulatory flexibility to address evolving risks and market practices, is a far more responsible approach, because this bill as drafted would appear to once again lock in extensions to the end-user exemption that are questionable wisdom narrowly and, in the aggregate, increasingly problematic.

[36] See 17 CFR Appendix F to Part 43, "Initial Appropriate Minimum Block Sizes by Asset Class for Block Trades and Large Notional Off-Facility Swaps."

Take a company that owns both commercial affiliates and financial affiliates. A conceptually rigorous approach to treating commercial end-users differently would only permit the parent to hedge the commercial risk of non-financial entities. This would require any financial affiliates to fully hedge their risk. Locking in a provision that permits the parent company to hedge the risks of the financial affiliate through the end-user exemption of the holding company violates the principles around the end-user exemption already discussed above. Continuing to expand these "end-user" exemptions undermines the financial stability benefits of derivatives regulation and puts at risk the reliability of the derivatives markets for entities that are genuine commercial end-users.

Owing to the breadth of its drafting, the bill may open up other risks. Proponents of the bill should more clearly explicate the concerns they are seeking to address, which will enable a more fulsome public policy debate and practical solutions, if appropriate, to emerge.

*H.R._____, To exclude non-U.S. regulated funds from the definition of "United States person" and ensure consistent application of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act to cross-border security-based swap and swap transactions, and for other purposes. (DERIV_010(2))*

This bill would rewrite the definition of "U.S. person" across every single rule, regulation, or guidance in the Federal securities laws and derivatives laws to exclude investment funds and commodity pools that are organized outside the United States, publicly offered to non-United States persons, and not publicly offered to United States persons. First, the circularity inherent in the bill itself could cause significant problems for the oversight of fund-of-fund and feeder fund structures. But, taking its attempted carve out on its face, the bill excludes an enormous swath of entities that would still be physically located and managed here in the United States and owned by United States citizens, U.S. pension funds, U.S. insurance companies, and other American investors.

This enormously overbroad and dangerous bill would create a U.S. based haven for fraudsters, market abuse, and risk, potentially outside the reach of any law. As such, it would gut anti-fraud

and many key regulatory protections that U.S. citizens, institutional investors, and others depend upon.

Nor is this “domestic Cayman Islands” approach cured by the fact that it would only be available to sophisticated U.S. entities or members of the foreign public. A large part of the failures and large losses during the financial crisis – ones that led to bailouts – occurred not in the retail markets but in the presumed sophisticated parts of the U.S. market. Even public listing, whether in the U.S. or outside, did not protect products from failure. That goes to show basic regulatory protections are critical for markets regardless of the size and sophistication of the parties.

Remember, strong cross-border regulation is essential for swapsbecause the risk can – because it historically has – come back to them United States. That can occur whether or not U.S. market participants in the relevant product or market are retail or institutional. Where foreign jurisdictions can stand up substantively comparable regimes, then U.S. regulators are in a position to recognize the compliance with those regimes. But opening up massive gaps in regulatory coverage through exclusions such as the one in this bill is a mistake of the largest proportion – one that would come back to haunt American and global financial stability and economic growth.

This bill would also undermine U.S. leadership in financial markets and regulation globally by creating a domestic regulatory haven right here in the U.S.

**Sensible Steps to Enhance Financial Stability and Promote Competition**

The United States financial markets are the most robust in the world because of the foundation provided by transparency, strong regulation, open competition, and the rule of law, including reliable, accountable and fair enforcement. The bills presented for consideration today chip – indeed, hack – away at that foundation, putting at risk America’s position as the go-to market for financial services. Instead of this approach, which would raise costs for end-users, grow monopoly, and imperil protections for U.S. taxpayers, the Committee should consider policies

that would enhance financial stability and promote competition in and through the derivatives markets.

First, the SEC should immediately finish and turn on its Title VII rules. In the interim, it should turn on portions that are completed, in particular market transparency provisions.

Second, the SEC and CFTC should work to dramatically expand, standardize, and make more publicly available the data that is and should be collected in the swaps markets. LEI should be a required part of every rule. Uniform product, transaction, and other identifiers should be implemented. Data should be required to be clean and far more available to public and researchers.

Third, as discussed above, the SEC should boost transparency across the derivatives markets by updating its financial institution disclosure guides to include significantly enhanced disclosures on derivatives activities, including and especially at the subsidiary level. As we have commented, the SEC should also enhance derivatives disclosures for non-financial firms, including at the subsidiary level, especially to help investors evaluate the risks and management of interaffiliate swaps.[37]

Fourth, the SEC and CFTC should both study high levels of market concentration in their respective swaps markets and develop policies designed to enhance competition.[38] This could include policies such as a) increasing requirements for pre-trade transparency (such as the number of quotes by SEFs); b) new rules and stronger enforcement related to conflict of interests, cartel-like practices uncovered in LIBOR, foreign exchange, and other markets, and the Volcker Rule; and even c) expanding the application of 10 percent market concentration caps under section 622 of the Dodd-Frank Act (itself, an expansion of the 10 percent cap on the deposit markets of the Riegle-Neal Act).

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[37] Andy Green and Gregg Gelzinis, Center for American Progress, "Letter to Brent Fields, Securities and Exchange Commission," July 7, 2017, available at https://www.sec.gov/comments/s7-02-17/s70217-1840087-154953.pdf

[38] On concentration, see Bank of International Settlements, *Statistical release OTC derivatives statistics at end-December 2016*, May 2017, 9, available at https://www.bis.org/publ/otc_hy1705.pdf; Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, Third Quarter 2017, graph 4, available at https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq317.pdf.

Fifth, the Committee should oppose the dismantling of oversight mechanisms governing systemically non-bank financial companies. As noted above, FSOC and OFR's abilities to monitor the markets and subject new emerging risks and institutions to oversight is being undone. If and when this results in a failure, the derivatives markets and those that rely on them will feel the damage.

Sixth, the Committee should work its colleagues on the Appropriations Committees to ensure the full funding of both the CFTC and SEC, especially with respect to their market monitoring and inspection functions. The former CFTC chairman wryly noted that "the amount of taxpayer dollars that were spent just to prevent the collapse of AIG as a result of its excessive swap risk was over 700 times the size of the CFTC's current budget."[39] Little has changed for the better on that front since 2015. Instead, the budgets for financial regulators and market oversight organizations, like FSOC and OFR, remain under pressure of cuts and constraints, including items such as the SEC's supplementary fund designed to support its long-term technology investment needs. Given the need to dramatically upgrade technological oversight across all the markets, this is the wrong direction.

Lastly, the Committee should explore the real risks that are emerging in the markets, and encourage regulators to do the same. The extraordinary – and somewhat inexplicable – volatility in the equity markets last week suggests that more needs to be done to first understand and then appropriately regulate increasing automation, growing use of volatility strategies, and the interactions between them. Given that these products are often directly (via exchange-traded notes) or indirectly (via exchange-traded funds' authorized participant structures) tied to large financial institutions, the Committee would be wise to ensure that the growing complexity and risk inherent in volatility trading does not put at risk the central nodes of the financial system or critical financial markets.

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[39] CFTC Chairman Timothy G. Massad, Testimony before the U.S. Senate Committee on Agriculture, Nutrition & Forestry, Washington, DC, May 14, 2015, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-22.