Testimony of Stephen O'Connor
Chairman
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Before the
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Committee on Agriculture
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Chairman Lucas, Ranking Member Peterson and Members of the Committee: Thank you for the opportunity to testify today.

In the nearly five years since the onset of the financial crisis, significant progress has been made in building a more robust financial system and a safer, more transparent over-the-counter (OTC) derivatives markets. Rule making is effectively a two stage process. First, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) created a legal framework for reform, and then the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have been charged with responsibility for creating market rules, effectively the implementation of the Act. Through this mechanism, a great deal of progress has been made towards a safer more robust financial system.

However, improvements can and should be made at both stages of this process. Contrary to Congress' stated intentions, the Dodd-Frank Act contains provisions that could actually increase, rather than decrease, systemic risk. This includes, for example, the law's Section 716 swaps push-out provision and also the requirement for mandatory initial margin for derivatives transactions. The rationale for, and value of, these provisions are uncertain. What is certain is that such provisions will impose significant costs and drags on the economy, without any clear countervailing benefits.

We also have concerns with regard to stage two, the interpretation and the implementation of the Act by the CFTC and the SEC. In some cases, different sections of the law are being construed differently by the different regulators. In others, regulators are interpreting and implementing the laws in ways that do not reflect the intent of Congress. For example:

- There is a significant risk that the goal of increased regulatory transparency is being undermined by the fragmentation of derivatives trade reporting;

- The CFTC and the SEC have taken different approaches to the cross-border application of derivatives rules, which could seriously impact market liquidity and the competitiveness of US firms in the global economy;

- The two US regulators also have different understandings of the law's trade execution requirements, which could lead to bifurcated market practices;

- The law's business conduct standards are being applied in a very prescriptive manner not envisioned by legislators, adding unnecessary costs and complexity to the system; and

- In some instances, the cost-benefit analysis required under the law is not being appropriately conducted, which could result in the imposition of rules that wind up doing more harm than good.

In these and other areas, there is significant concern that the law will be inconsistently and inappropriately applied. This could increase rather than decrease risk, raise costs and prevent the sound application of risk management practices that are essential to the proper functioning of markets and to a healthy, productive American economy.

I will address each of these points in more detail, but before I do, it's important to state quite clearly: The International Swaps and Derivatives Association squarely supports financial regulatory reform that is designed to build a strong, safe financial system, reduce systemic risk, decrease counterparty credit risk and improve regulatory transparency. This, indeed, is our mission: to foster safe and efficient derivatives markets for all users of derivatives products. ISDA has worked for 25 years on measures such as the significant reduction of credit and legal risk by developing a framework of legal certainty which includes the ISDA Master Agreement and related standardized collateral agreements. The Association has also been a leader in promoting sound risk management practices and processes and has for 12 years been a strong advocate of the appropriate use of central clearinghouses

Today, ISDA has more than 800 members from 60 countries on six continents, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, as well as international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. The Association's broad market representation is further reflected by the number of non-dealer firms on our board of directors and their representation on key ISDA committees.

ISDA believes that the most effective way to achieve the goal of greater systemic resiliency is through a regulatory framework that includes: appropriate capital standards, mandatory clearing requirements where appropriate, robust collateral requirements and mandatory trade reporting obligations. We have worked actively and are engaged constructively with policymakers in the US and around the world on these important initiatives. Great strides have been made in all of these areas.

For example, trade repositories have been established covering derivatives in all major asset classes – interest rates, credit, equities, commodities and foreign exchange. Regulators around the world now have comprehensive access to information about trading activity in the derivatives market. Regulators will now be able to readily identify where risk may be building up in the system as well as detect improper behavior, observe transaction flows and identify trends in liquidity in the OTC markets. However, as discussed in greater detail below, significant work remains to ensure that this information is completely visible to regulators and a major opportunity is not lost.

With regard to clearing of derivatives through central counterparties, nearly two-thirds of the interest rate swap market is already centrally cleared, largely due to voluntary initiatives and commitments by banks to global regulators in advance of the Dodd-Frank Act required mandates. Clearing will increase significantly in the next twelve to twenty-four months as trades between dealers and their clients become subject to mandatory clearing, which began in the US in March 2013.

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Let me turn briefly to what we believe are two of the most significant areas of the Dodd-Frank Act that could benefit from action by Congress: the swaps push-out provision and the initial margin requirements.

Section 716 Swaps Push-Out Provision

The Dodd-Frank Act's Section 716, commonly called the "Swap Push-Out" provision, requires banks to separate and segregate portions of their derivative businesses, including equity derivatives, certain CDS and commodity derivatives transactions, outside of entities that receive federal assistance, including the federal deposit insurance program or access to the Federal Reserve's discount window. These activities would have to be conducted in separately capitalized affiliates, legally apart from entities such as FDIC-insured banks. We should also note that, due to a drafting error, certain non-US-based firms with significant US operations and US employees could be harmed further, as they would not be able to take advantage of certain statutory exemptions contained in Section 716.

While the ostensible purpose of Section 716 is to reduce risk, forcing derivatives activities outside of a better-capitalized, better-regulated bank into new standalone subsidiaries could actually increase risk to the system. This perverse outcome has been noted by the FDIC, Federal Reserve, former Treasury Secretary Geithner and even former Federal Reserve Chairman Paul Volcker. Section 716 will also lead to greater inefficiencies and the loss of exposure netting as it requires firms to conduct swaps across multiple legal entities.

There are other disadvantages to Section 716 as well. It will tie up additional capital that might better be used to support investment, and create higher funding and operational costs for the financial institutions that are required to implement it.

Those financial institutions currently include only firms doing business in the US, as there is no similar law or regulation in place in any major foreign jurisdiction. These firms will be at a competitive disadvantage to their non-US counterparts. American customers of these firms would therefore face higher costs, or will seek out lower cost non-US firms to assist with their risk management initiatives and transactions.

Customers will also need to evaluate the strength and capital of each Section 716 subsidiary that they may do business with, rather than that of the parent company, which will also impact these subsidiaries' competitiveness. Section 716 also complicates the ability of financial institutions to net their exposures and to manage their risks most efficiently.

Due to the above noted issues, ISDA has expressed support for H.R. 992, legislation passed by this Committee and the Financial Services Committee.

Initial Margin Requirements

The Dodd-Frank Act adds section 4s(e) to the Commodity Exchange Act to address capital and margin requirements for swap entities.

ISDA and the industry support the intent of global policymakers to develop a regulatory framework that improves the safety of the global over-the-counter derivatives markets, and further recognize the need for robust variation margin requirements, particularly for systemically important firms. That said, we harbor grave concerns regarding Dodd-Frank's initial margin (IM) requirements.

IM is designed to cover the replacement costs if a counterparty defaults. It is an extra payment made between parties in excess of amounts owed, and as such, it improves the situation of the non-defaulting party.

While initial margin has benefits, it is important to understand the very real and very significant costs that it would impose. Depending on how IM requirements are developed and implemented:

- The initial margin requirement has the potential to significantly strain the liquidity and financial resources of the posting party;
- In stressed conditions, the initial margin requirements will result in greatly increased demand for new funds at the worst possible time for market participants; and
- The initial margin requirements could cause market participants to reduce their usage of non-cleared OTC derivatives and: (1) choose less effective means of hedging, (2) leave the underlying risks unhedged, or (3) decide not to undertake the underlying economic activity in the first instance due to increased risk that cannot be effectively hedged.

Perhaps most importantly, we do not believe that initial margin will contribute to the shared goal of reducing systemic risk and increasing systemic resilience. When robust variation margin practices are employed, the additional step of imposing initial margin imposes an extremely high cost on both market participants and on systemic resilience with very little countervailing benefit.

The Lehman and AIG situations highlight the importance of variation margin. . AIG did not follow sound variation margin practices, which resulted in dangerous levels of credit risk building up, ultimately leading to its bailout. Lehman, on the other hand, posted daily variation margin, and while its failure caused shocks in many markets, the variation margin prevented outsized losses in the OTC derivatives markets.

While industry and regulators agree on a robust variation margin regime including all appropriate products and counterparties, the further step of moving to mandatory IM does not stand up to any rigorous cost benefit analysis.
We recognize that it would take Congressional action to amend the Act and the IM requirement. In the absence of such amendment, we believe it imperative that the regulators implement the IM requirement in a prudent way that does not introduce overwhelming costs, reduce liquidity and directly harm the US economy.

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Moving to further comments on implementation, as noted above, there are challenges related to an inconsistent interpretation of the law, and an interpretation that does not reflect the original intent of the legislation.

Swap Data Repositories

Perhaps the most important of these issues is related to fragmentation of trade reporting by OTC derivatives markets participants.

One of the major lessons learned of the financial crisis is the need for regulators and supervisors to have clear and comprehensive access and insights into the level and type of risk exposures at financial institutions and their counterparties. One of the most important achievements of policymakers and market participants in the past five years has been the establishment of global trade databases, or swaps data repositories, that accomplish this goal. Such repositories have been built for all major derivatives asset classes. The level of information they contain is unparalleled in the global financial markets.

This progress is now at risk. Because of current regulatory interpretation regarding collection and reporting of cleared trades, it seems likely that there will not be one central information warehouse that collects all derivatives market data. This data could be splintered into multiple warehouses. If this happens, then regulators would essentially be forced to follow their previous, pre-crisis practices. They would have to go from repository or repository to collect and to attempt to aggregate exposures, just as they used to go from firm to firm for data. Such attempts to aggregate will be near-impossible if fragmentation really takes hold.

Systemic risk would not be reduced. Regulatory visibility and the ability to identify where risk is building up in the system would be fatally impaired.

A fantastic opportunity will have been missed. The amount and completeness of information that could be available to regulators is unprecedented in global financial markets. For no other financial instrument, in any asset class, has there ever been a way for authorities to access a complete database of the entire global transaction population.

Cross-Border Application of Rules

Concerns are also growing about the potential application, impact and consistency of the US regulatory framework in other jurisdictions. This was most recently and pointedly evidenced by the April 18 letter from finance officials representing nine of the world's largest countries - imploring Treasury Secretary Lew to limit the cross-border reach of Dodd-Frank Act swaps rules. These issues are raising the prospect that market participants will be subject to duplicative and/or contradictory regulatory mandates from the EU and other non-US jurisdictions that would impose significant costs, fragment market liquidity and potentially create an uneven playing field. As the letter states, "An approach in which jurisdictions require that their own domestic regulatory rules be applied to their firms' derivatives transactions taking place in broadly equivalent regulatory regimes abroad is not sustainable."

ISDA and our members believe that a globally harmonized approach to cross-border regulation is of paramount importance. What they face now is considerable uncertainty. Uncertainty is never a good thing in financial markets, as there are typically only two things to do in face of that uncertainty. One response is to pull back and wait until such time as greater certainty is provided. On a firm level, that means missed opportunity. On a market level, that translates to less efficient, less liquid and more volatile markets, material harm to financing and investing activities and a drag on the economy in general.

The other response is to try to anticipate various possible results. This can lead to costly, duplicative efforts with no guarantee that all that planning will prove effective once the rules are finalized.

Either path runs the risk of undermining the safe, efficient markets that ISDA, regulators and the industry all desire.

To achieve the goal of a globally harmonized framework, the CFTC and SEC should work together to achieve consensus with global regulators. H.R. 1256 would help the US regulators to provide a unified front when addressing the extraterritorial application of US rules and when dealing with non-US regulators. Harmonization of regulatory approaches, particularly on issues with systemic risk implications, and a concerted program of mutual recognition of regulatory regimes by global regulators are essential parts of the solution to ET.

Trade Execution Requirements

The inconsistent interpretation of the law by the CFTC and the SEC is apparent in the recently finalized CFTC swap execution facility (SEF) requirements which mandate initially two, and later three, requests for quotes (RFQs).

To our knowledge, no objective or empirical evidence exists as to why multiple RFQs are beneficial to the market and no research has been done to this effect. In fact, ISDA's members from the buy-side community have expressed concern that a multiple-RFQ model will harm, rather than help, their execution.

For example, the CFTC rule may result in increased transaction costs, and in an ISDA survey of the buy-side, 70 percent of respondents indicated they would migrate to other markets if required to post multiple RFQs. In fact, 76 percent indicated it would have a negative effect on liquidity.

Many buy-side firms have very serious concerns about being forced to request a quote from more than one dealer because that can cause a signaling effect, exposing their investment strategy to multiple market participants. A provision that has been put forth as a benefit for end-users is being soundly rejected by them.

In addition to these issues, the CFTC regulation for SEFs will limit the means by which swaps can be executed to two types of platforms: an electronic order book and an RFQ system.

Business Conduct Rules

Dodd-Frank required the development of Business Conduct rules as a form of customer protection in the swaps market. Regulators have in the past several years developed business conduct rules required of market participants, particularly swap dealers. These rules are extremely detailed and prescriptive and they impose a large compliance burden on market participants that is well outside the scope of what Congress apparently intended.

The rules impose significant additional requirements on swap dealers in respect to their relationships with their customers. Since the majority of external business conduct rules became effective May 1, we have yet to see whether the significant compliance requirements translate into increased customer protection.

To facilitate compliance with these requirements, ISDA has created and managed two industry-spanning protocols directly related to Dodd-Frank. Protocols intend to get the majority of market participants to agree to new transaction terms that reflect the regulatory changes in the law, by adhering to these changes through an electronic market-wide process. The August 2012 Dodd-Frank ISDA Protocol addresses compliance with the CFTC's External Business Conduct Rules; a second protocol facilitates compliance with the CFTC's rules on Swap Trading Relationship Documentation and Clearing Requirements.

Cost-Benefit Analysis

The business conduct standards rules described above, and ISDA's work to fulfill those that have been finalized, clearly illustrate the cost and expense related to certain Dodd-Frank provisions. What is less clear, however, are the benefits that these and other aspects of the law and their regulatory interpretation bring to our country's financial system and the thousands of companies that use OTC derivatives.

An appropriate cost-benefit analysis was both required and desirable prior to finalization of rules; however in a number of instances the CFTC's analysis did not comply with the regulatory standard.

As the Jun 2012 report by the CFTC Inspector General stated:

> "….Generally speaking, it appears CFTC employees did not consider quantifying costs when conducting cost-benefit analyses for the definitions rule. As indicated in the rule's preamble, the costs and benefits associated with coverage under the various definitions (in light of the various regulatory burdens that could eventually be associated with coverage) were not addressed…."

The lack of an appropriate cost-benefit analysis makes it especially important that the application and implementation of the final rules be phased in a flexible manner. Doing so would help ensure that rules achieve the purposes for which they are intended and do not impose burdensome costs on the financial system. It would also help regulators to identify and avoid unintended consequences of their actions. And it would encourage regulators to properly allocate limited resources.

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In conclusion, ISDA remains committed to achieving a safer, more efficient and more robust financial system and OTC derivatives markets.

Toward that end, it is vitally important that we, industry and regulators, focus our resources on those aspects of regulatory reform that address the most important issue – reducing systemic risk. This includes appropriate capital, central clearing and variation margin frameworks as well as regulatory transparency.

At the same time, it is vitally important that we seek to avoid burdensome measures that do not pose any clear, tangible benefit, and that divert resources from being allocated more efficiently elsewhere and impede progress in more important areas. Or worse still, enacting measures that harm liquidity or reduce systemic resiliency in the very markets they are trying to protect, resulting in a direct and harmful impact on the economy. This is particularly critical given the slow and uneven growth of the US and the global economy.

Dodd-Frank is an important step forward for our country and our markets. And the CFTC deserves our sincere appreciation and support for its efforts in implementing its wide-ranging provisions in a relatively short period of time. It is clear, however, that our experience over the past several years has shown that not all of the law's provisions are appropriate and contribute to the overriding goal of a safer financial system. Similarly, some efforts by the regulators to implement the law are inconsistent with the intent of Congress, are being interpreted in different ways by various agencies, or impose costs that far exceed any resulting benefits.

In light of these concerns and observations, ISDA respectfully requests this Committee to (1) support the amending of Section 716, which could be done in an effective way through passage of H.R. 992 (2) consistent with H.R. 1256, stress to the CFTC the necessity of a flexible, prudent interpretation of the statutory provisions on margin and work closely with the industry to adopt final regulations that ensure the safety of the markets but do not harm liquidity and market participants; (3) urge the SEC and CFTC to harmonize their cross-border rules as soon as possible so US regulators speak with one voice in the ongoing global debate on extraterritoriality since this is necessary to ensure the competitiveness of US markets and the efficient flow of capital throughout all the global markets in which US businesses operate.

Thank you.

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STEPHEN O'CONNOR
Chairman
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. (ISDA)

Mr. O'Connor takes a leading role in derivatives industry reform. He was elected Chairman of the Board of Directors of the International Swaps and Derivatives Association (ISDA) in April 2011. From November 2008 to April 2011, he served as Chair of ISDA's Industry Governance Committee (IIGC). Mr. O'Connor has worked extensively with global regulators and market participants on industry reform matters, including industry voluntary commitments to global supervisors.

In his 24 year career at Morgan Stanley, Mr. O'Connor has served in a number of senior positions. Most recently, he led the build of the firm's OTC derivatives client clearing business and just prior to that he served as Global Head of Counterparty Portfolio Management and Head of CVA Trading.

Mr. O'Connor served as a member of the Counterparty Risk Management Policy Group II initiative (CRMPGII). He was a member of the High Level Stakeholder Group advising the UK Government review of the Future of Computer Trading in Financial Markets and he is a member of the Global Markets Advisory Committee (GMAC) of the US Commodity Futures Trading Commission.

Mr. O'Connor graduated from Imperial College, London with a B.Sc. (Eng.) in Mechanical Engineering.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2010.

Name: Stephen O'Connor

Organization you represent (if any): International Swaps and Derivatives Association, Inc. (ISDA)

1. **Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2010, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: NONE **Amount:**____________

Source:____________ **Amount:**____________

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2010, as well as the source and the amount of each grant or contract:**

Source: NONE **Amount:**____________

Source:____________ **Amount:**____________

Please check here if this form is NOT applicable to you: ____________

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