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"Building the New Derivatives Regulatory Framework:
Oversight of Title VII of the Dodd-Frank Act."
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Chairman Johnson, Ranking Member Shelby, and members of the Committee, thank you for inviting me to testify today about Treasury's role in implementing the derivatives provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

As you know, the President signed the Dodd-Frank Act into law almost nine months ago. The Act established a framework for the country to build a stronger, safer, and more competitive financial system. It creates safeguards to protect consumers and investors, end taxpayer bailouts, and improve the transparency, efficiency, and liquidity of U.S. markets. The Dodd-Frank Act's derivatives provisions are an important part of that framework.

During the nine months since the Dodd-Frank Act became law, the Treasury Department, other parts of the Administration, and independent regulatory agencies have been working diligently to build out the framework according to the directions provided by the statute. As we implement the Dodd-Frank Act, we have focused on advancing the best interests of consumers, investors, and taxpayers while also preserving the best attributes of and improving upon a financial system that encourages investment and promotes growth.

As other Treasury officials have previously testified before this Committee, several broad principles guide our efforts:

- 1) We are moving as quickly as we can to carry out the intent of Congress and meet the deadlines that the Dodd-Frank Act established, but we are also moving carefully to make sure that as we implement the Act, we get it right.
- 2) We are bringing full transparency to the process so that as many stakeholders as possible have a seat at the table, so that the American people know who is at that table, so that proposed rules and even advance notices of proposed rulemakings and requests for comments are published, and so that anyone who wants to comment can do so.
- 3) We are creating a more coordinated regulatory process. We will eliminate gaps that allowed risks to grow unchecked and permitted a race to the bottom in certain areas. The Financial Stability Oversight Council (FSOC) is playing a key role in these efforts by bringing together the financial regulatory agencies to help develop consistent and comparable regulations and supervisory regimes across different agencies.
- 4) We are building a level playing field that treats market participants equally, whether they are banks or non-banks, and whether they are domestic or foreign institutions. We are setting high standards in the United States and working diligently with our international counterparts to encourage them to set similar standards.
- 5) We are crafting rules of the road that will provide U.S. investors and institutions the confidence, the certainty, and the incentives they need to invest capital, develop innovative products and services, and compete globally.
- 6) Finally, we are committed to keeping Congress fully informed of our progress on a regular basis.

Just as these guiding principles apply broadly to Dodd-Frank Act implementation efforts, they also apply to implementation of the Dodd Frank Act's derivatives provisions in particular.

Our partners at the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the Board of Governors of the Federal Reserve System (Federal Reserve Board), all of whom are represented here today, have been and will continue to be instrumental in achieving the goals of the Dodd-Frank Act. As you will hear from Chairman Gensler, Chairman Schapiro and Governor Tarullo, their agencies' roles in implementing the Act's derivatives provisions are particularly important.

While Treasury has a more limited role than the CFTC, SEC, and Federal Reserve Board in building Dodd-Frank's new derivatives regulatory framework, the Secretary of the Treasury (Secretary) does have certain specific statutory responsibilities under the Dodd-Frank Act and has other responsibilities in his capacity as the Chairman of the FSOC.

Starting with the specific responsibilities under the Dodd-Frank Act, Congress gave the Secretary the authority to determine whether foreign exchange (FX) swaps and forwards should be exempted from the definition of "swap" in the Commodity Exchange Act (CEA) (7 U.S.C. ch. 1). Foreign exchange swaps and forwards generally are subject to the requirements of the CEA. For these instruments, the most significant requirements under the regulatory regime enacted by the Dodd-Frank Act would be central clearing and exchange trading requirements for foreign exchange swaps and forwards, unless the Secretary determines that they "(I) should not

be regulated as swaps under [the CEA]; and (II) are not structured to evade [the Dodd-Frank Act] in violation of any rules promulgated by the [CFTC]” pursuant to the Dodd-Frank Act.¹

The statute limits the scope of a determination to foreign exchange swaps and forwards and does not allow the Secretary to exempt other foreign exchange derivatives, such as foreign exchange options, currency swaps, and non-deliverable forwards. These other foreign exchange derivatives do not satisfy the narrow definition of a “foreign exchange swap” or “foreign exchange forward” and, therefore, may not be exempted.

Under the CEA as amended by the Dodd-Frank Act, and for purposes of the Secretary’s determination, an FX swap is defined as “a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange” and “(B) a reverse exchange of [those two currencies] at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange.”² Likewise, the CEA as amended narrowly defines an FX forward as “a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.”³

In determining whether to exempt foreign exchange swaps and forwards, the Secretary must consider the following five statutory factors set forth by the Dodd-Frank Act:

¹ 7 U.S.C. 1a(47)(E)(i).

² 7 U.S.C. 1a(25).

³ 7 U.S.C. 1a(24).

- 1) Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States;
- 2) Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps;
- 3) The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements;
- 4) The extent of adequate payment and settlement systems; and
- 5) The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.⁴

If the Secretary determines that foreign exchange swaps or forwards should be exempted from the CEA's definition of "swap," Treasury must provide a written determination to Congress that contains: (1) "an explanation of why [FX] swaps and [FX] forwards are qualitatively different from other classes of swaps in a way that would make the [FX] swaps and [FX] forwards ill-suited for regulation as swaps;" and (2) "an identification of the objective differences of [FX] swaps and [FX] forwards with respect to standard swaps that warrant an exempted status."⁵

Consistent with Treasury's commitment to an open and transparent process, on October 28, 2010, we published a Notice and Request for Comments (Notice) in the Federal Register to solicit public comment on a wide range of issues relating to whether foreign exchange swaps and

⁴ 7 U.S.C. 1b(a).

⁵ 7 U.S.C. 1b(b).

foreign exchange forwards should be exempt from the definition of the term “swap” under the CEA. We received approximately thirty comments in response to the Notice, and Treasury staff has also conducted its own, independent analysis of the issue, including extensive discussions with a range of regulators, end users, dealers, and other interested parties.

We know that this is an issue that market participants and other stakeholders are interested in, and we recognize that the Committee is also closely following this issue. Like other areas of Dodd-Frank implementation and consistent with the guiding principles identified above, this is an area where we want to move expeditiously. Regardless of the decision the Secretary pursues, market participants need to know what the regulatory regime will look like and to be able to plan and prepare for that regime. But it is also critical that we take enough time to be confident that we are making the right decision for the safety and soundness of the markets.

In addition to his specific duties under the Dodd-Frank Act, the Secretary also has more general responsibilities with respect to the Act’s derivatives provisions in his capacity as Chairman of the FSOC. In March, the FSOC held its fourth meeting and approved the publication of a Notice of Proposed Rulemaking (NPRM) regarding the FSOC’s designation of financial market utilities (FMUs) as systemically important.

FMUs exist in many financial markets to support and facilitate the transfer, clearing, and settlement of financial transactions, and they form a critical part of the nation’s financial market infrastructure. FMUs’ functions and interconnectedness with many parts of the market can help manage and reduce risk, but if they are poorly operated could also concentrate risk. Title VIII of

the Dodd-Frank Act recognizes both their important role in our economy and the potential systemic risks they might create if not properly managed and supervised. To address the potential for such risks, the Act seeks to enhance the regulation and supervision of systemically important FMUs to promote robust risk management and safety and soundness.

The FSOC published an advance notice of proposed rulemaking regarding the criteria for designating systemically important FMUs on December 21, 2010. After receiving, reviewing, and analyzing comments received in response to the advance notice and performing additional work, at its March meeting the FSOC approved the publication of the NPRM. The NPRM was published in the Federal Register on March 28, 2011, and the comment period will be open for sixty days for any interested party to submit comments on the proposed rule.

Title VIII of the Dodd-Frank Act also gives the FSOC the responsibility of designating systemically important payment, clearing, and settlement (PCS) activities that occur at financial institutions other than FMUs. These PCS activities could occur between financial institutions transacting with each other or between a financial institution and one of its customers. The FSOC's member agencies and staff have started examining this issue as well, and the FSOC will proceed in the coming months with the necessary rulemaking to establish the criteria and procedures for the FSOC's designation of PCS activities as systemically important.

One final area I would like to touch on is the importance of the comparability of international standards that will apply to the financial regulatory framework in general, including derivatives regulation. The United States will set high standards and take the steps that are necessary for the

safety and soundness of our financial system. But today's financial system is highly interconnected, mobile, and global. It is important that we pursue as level an international playing field as possible not only to protect the competitiveness of U.S. financial markets and institutions but also to ensure that the critically important reforms we implement here cannot be evaded or rendered ineffective by lax standards elsewhere.

With respect to the international derivatives regulatory framework, significant globally-coordinated work has already occurred, but more remains to be done. Treasury and our international counterparts are focused on making certain that critical over-the-counter derivative market infrastructure is subject to appropriate oversight. A key element of our current discussions is ensuring that we have cooperative oversight frameworks in place to address the information needs of supervisors in different jurisdictions.

We will continue to work at home and with our international counterparts to build a regulatory framework for derivatives that will help our financial system become safer and sounder and a sound platform on which we can build strong financial markets that will fuel the nation's economic growth.