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BEFORE THE

U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

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Good morning Chairman Johnson, Ranking Member Shelby and members of the Committee. I thank you for inviting me to today's hearing on implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), international harmonization of swaps market reforms, and the Commodity Futures Trading Commission's (CFTC) role in overseeing markets for credit derivative products, such as those traded by JPMorgan Chase's Chief Investment Office. I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation. I'm pleased to testify along with Securities and Exchange Commission (SEC) Chairman Schapiro.

Swaps, now comprising a $700 trillion notional global market, were developed to help manage and lower risk for commercial companies. But they also concentrated and heightened risk in international financial institutions. And when financial entities fail, as they have and surely will again, swaps can contribute to quickly spreading risk across borders.

As the financial system failed in 2008, most of us learned that the insurance giant AIG had a subsidiary, AIG Financial Products, originally organized in the United States, but run out of London. The fast collapse of AIG, a mainstay of Wall Street, was again sobering evidence of the markets' international interconnectedness. Sobering evidence, as well, of how transactions booked in London or anywhere around the globe can wreak havoc on the American public.

Recently, we've had another stark reminder of how trades overseas can quickly reverberate with losses coming back into the United States. According to press reports, the largest U.S. bank, JPMorgan Chase, just suffered a multi-billion dollar trading loss from transactions in London. The press also is reporting that this trading involved credit default swaps and indices on credit default swaps. It appears that the bank here in the United States is absorbing these losses. And as a U.S. bank, it is an entity with direct access to the Federal Reserve's discount window and federal deposit insurance.

I am authorized by the Commission to confirm that the CFTC's Division of Enforcement has opened an investigation related to credit derivative products traded by JPMorgan Chase's Chief Investment Office. Although I am unable to provide any specific information about a pending investigation, I will describe generally the Commission's oversight of the swaps markets, the entities and products in our jurisdiction, and the Dodd-Frank reforms relevant to credit default swaps, and in particular index credit default swaps.

The role the unregulated swaps market played in the 2008 crisis led to a new international consensus that the time had come for comprehensive regulation. Swaps, which were basically not regulated in Asia, Europe and the United States, should now be brought into the light of regulation.

When President Obama gathered together the G-20 leaders in Pittsburgh in 2009, they agreed that the swaps market needed to be reformed and that such reform should be completed by December 2012.

In 2010, Congress and the President came together and passed the historic Dodd-Frank Act.

The goal of the law is to:

- Bring public market transparency and the benefits of competition to the swaps marketplace;
- Protect against Wall Street's risks by bringing standardized swaps into centralized clearing; and
- Ensure that swap dealers and major swap participants are specifically regulated for their swap activity.

Despite different cultures, political systems and financial systems, we've made significant progress on a coordinated and harmonized international approach to reform. Japan passed reform legislation in 2010, and has made real progress on their clearing mandate. Further, they have a proposal before their Diet on the use of trading platforms, as well as post-trade transparency. The European parliament last month adopted the European Market Infrastructure Regulation (EMIR) that includes mandatory clearing, reporting and risk mitigation for derivatives. And the European Commission has published proposals providing for both pre-trade and post-trade transparency. Other major jurisdictions, including the largest provinces in Canada, have the legislative authority and have made progress on swaps reform.

Implementation of Dodd-Frank Swaps Market Reforms

The CFTC has made significant progress in completing the reforms that will bring transparency to the swaps market and lower its risk to the rest of the economy.

During the rule-writing process, we have benefitted from significant public input. CFTC Commissioners and staff have met over 1,600 times with the public and we have held 16 public roundtables on important issues related to Dodd-Frank reform.

We are consulting closely with other regulators on Dodd-Frank implementation, including the SEC, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and other prudential regulators. This coordination includes sharing many of our memos, term sheets and draft work product. In addition, we are actively consulting with international regulators to harmonize our approach to swaps oversight, and share memos, term sheets and draft work product with our international counterparts as well.

We substantially finished our proposal phase last spring, and then largely reopened the mosaic of rules for additional public comments. We have accepted further public comment after the formal comment periods closed. The agency received 3,000 comment letters before we proposed rules and more than 28,000 comment letters in response to proposals.

Last summer, we turned the corner and started finalizing rules. To date, we've completed 33 rules with less than 20 more to go.

The Commission is turning shortly to the rule to further define the terms "swap" and "security-based swap," the second of the two key joint further definition rules with the SEC. The staff recently has put forth to the Commission a final rule for our consideration. It is essential that the two Commissions move forward on the further product definition rulemaking expeditiously.

Consistent with the provisions of the Dodd-Frank Act, the proposal states the CFTC regulates credit default swaps on broad-based security indices, while the SEC regulates them on narrow-based security indices (as well as credit default swaps on single name securities or loans). Under the proposal, most of the credit default swap indices compiled by the leading index provider, Markit, generally would be broad-based indices. These indices would generally include, but not be limited to, Markit's CDX North American Investment Grade, as well as its CDX North American High Yield. While the credit default swaps based on these indices would be swaps under CFTC jurisdiction, the SEC would retain certain anti-fraud and anti-manipulation enforcement authorities over them as well, as it had prior to Dodd-Frank.

Transparency

The Dodd-Frank financial reform shines bright lights of transparency – to the public and to regulators – on the swaps market for the benefit of investors, consumers, retirees and businesses in America. Transparency is critical to both lowering the risk of the financial system, as well as reducing costs to end-users. The more transparent a marketplace is to the public, the more efficient it is, the more liquid it is, and the more competitive it is.

The CFTC has completed key rules on transparency that, for the first time, provide a detailed and up-to-date view of the physical commodity swaps markets so regulators can police for fraud, manipulation and other abuses. We have begun to receive position information for large traders in the swaps markets for agricultural, energy and metal products.

We also finished a rule establishing registration and regulatory requirements for swap data repositories, which will gather data on all swaps transactions.

Starting this summer, real-time reporting to the public and to regulators will begin for interest rate and credit default swaps with similar reporting on other swaps later this year. Also later this year, market participants will benefit from the transparency of daily valuations over the life of their swaps.

By contrast, in the fall of 2008, there was no required reporting about swaps trading.

This month, we completed rules, guidance and acceptable practices for designated contract markets (DCMs). DCMs will be able to list and trade swaps, helping to bring the benefit of pre-trade transparency to the swaps marketplace.

Looking forward, we have two important remaining transparency rules to complete related to block sizes and swap execution facilities (SEFs). The trading of credit default swap indices will benefit from the transparency provided on SEFs.

The Japanese and European transparency proposals, as well as initiatives well underway in other jurisdictions, will further align international reform efforts and benefit the public.

Central Clearing

For over a century, through good times and bad, central clearing in the futures market has lowered risk to the broader public. Dodd-Frank financial reform brings this effective model to the swaps market. Standard swaps between financial firms will move into central clearing, which will significantly lower the risks of the highly interconnected financial system.

The CFTC has made significant progress on central clearing for the swaps market. We have completed rules establishing new derivatives clearing organization risk management requirements. To further facilitate broad market access, we completed rules on client clearing documentation, risk management, and so-called “straight-through processing,” or sending transactions immediately to the clearinghouse upon execution.

In addition, the Commission has adopted important customer protection enhancements. The completed amendments to rule 1.25 regarding the investment of funds bring customers back to protections they had prior to exemptions the Commission granted between 2000 and 2005. Importantly, this prevents use of customer funds for in-house lending through repurchase agreements. Clearinghouses also will have to collect margin on a gross basis and futures commission merchants will no longer be able to offset one customer’s collateral against another and then send only the net to the clearinghouse. And the so-called “LSOC rule” (legal segregation with operational comingling) for swaps ensures customer money is protected individually all the way to the clearinghouse.

Furthermore, Commissioners and staff have gotten a lot of feedback from market participants on additional customer protection enhancements, including through a public roundtable. Staff is actively seeking further public input through our website and further meetings. Staff will use this outreach and review to put forward recommendations to the Commission for consideration. In addition, the National Futures Association and the CME Group have proposals for greater controls for segregation of customer funds. CFTC staff is working with these self-regulatory organizations on their proposals.

CFTC staff now is preparing recommendations for the Commission and for public comment on clearing requirement determinations. The Commission's first determinations will be put out for public comment this summer and hopefully completed this fall. They will begin with key interest rate products, as well as a number of CDX and iTraxx credit default swap indices. There is a great deal of consistency among the major jurisdictions on the clearing requirement, and the CFTC's timeframe broadly aligns with both Japan and Europe.

Currently, clearing exists for much of the standardized interest rate swaps, as well as for credit default swap indices, done between dealers. The major clearinghouses providing swaps clearing are registered with the CFTC.

Moving forward, the Commission will consider a final rule on the implementation phasing of the clearing requirement and the end-user exception related to non-financial companies.

Swap Dealers

Regulating banks and other firms that deal in derivatives is central to financial reform. Prior to 2008, it was claimed that swap dealers did not need to be specifically regulated for their swaps activity, as they or their affiliates already were generally regulated as banks, investment banks, or insurance companies. The crisis revealed the inadequacy of relying on this claim. While banks were regulated for safety and soundness, including their lending activities, there was no comprehensive regulation of their swap dealing activity. Similarly, bank affiliates dealing in swaps, and subsidiaries of insurance and investment bank holding companies dealing in swaps, were not subject to specific regulation of their swap dealing activities. AIG, Lehman Brothers and other failures of 2008 demonstrate what happens with such limited oversight.

The CFTC is well on the way to implementing reforms Congress mandated in Dodd-Frank to regulate dealers and help prevent another AIG. The Commission has finished sales practice rules requiring swap dealers to interact fairly with customers, provide balanced communications and disclose conflicts of interest before entering into a swap. In addition, this agency has finalized internal business conduct rules to require swap dealers to establish policies to manage risk, as well as put in place firewalls between a dealer's trading, and clearing and research operations.

We completed in April a joint rule with the SEC further defining the terms "swap dealer" and "securities-based swap dealer," which is pivotal to lowering the risk they may pose to the rest of the economy.

Based on completed registration rules, dealers will register after we finalize the second major definition rule with the SEC: the further definition of the terms "swap" and "securities-based swap." Swap dealers who make markets in credit default swap indices would be amongst those dealers who may have to register with the CFTC.

Following Congress' mandate, the CFTC also is working with our fellow financial regulators to complete the Volcker rule, which prohibits certain banking entities from engaging in proprietary trading. In adopting the Volcker rule, Congress prohibited banking entities from proprietary trading, an activity that may put taxpayers at risk. At the same time, Congress permitted banking entities to engage in certain activities, such as market making and risk mitigating hedging. One of the challenges in finalizing a rule is achieving these multiple objectives.

The international community is closely coordinating on margin requirements for uncleared swaps, and is on track to seek public comment in June on a consistent approach. This is critical to reducing the opportunity for regulatory arbitrage. The CFTC's proposed margin rule excludes non-financial end-users from margin requirements for uncleared swaps. I've been advocating with global regulators that we all adopt a consistent approach.

The Commission is working with fellow regulators here and abroad on an appropriate and balanced approach to the cross-border application of Dodd-Frank swaps market reforms. The CFTC will soon seek public comment on guidance regarding the cross-border application of Title VII rules.

Market Integrity/Position Limits

Financial reform also means investors, consumers, retirees and businesses in America will benefit from enhanced market integrity. Congress provided the Commission with new tools in Dodd-Frank to ensure the public has confidence in U.S. swaps markets.

Rules the CFTC completed last summer close a significant gap in the agency's enforcement authorities. The rules implement important Dodd-Frank provisions extending our enforcement authority to swaps and prohibited the reckless use of manipulative or deceptive schemes. Thus, for example, the CFTC has clear anti-fraud and anti-manipulation authority regarding the trading of credit default swaps indices.

Also, the CFTC now can reward whistleblowers for their help in catching market misconduct.

Congress also directed the CFTC to establish aggregate position limits for both futures and swaps in energy and other physical commodities. In October 2011, the Commission completed final rules to ensure no single speculator is able to obtain an overly concentrated aggregate position in the futures and swaps markets. The Commission's final rules require compliance for all spot-month limits 60 days after the CFTC and SEC jointly adopt the rule to further define the term "swap" and "securities-based swap" and for certain other limits, following a collection of a year's worth of large trader swap data. Two associations representing the financial industry, however, are challenging the agency's final rule establishing those limits in court. The Commission is vigorously defending the Congressional mandate to implement position limits in court.

Last week, the Commission approved a proposed rule that would modify the CFTC's aggregation provisions for limits on speculative positions. The proposal would permit any person with a 10 to 50 percent ownership or equity interest in an entity to disaggregate the owned entity's positions, provided there are protections and firewalls in place to ensure trading decisions are made independently of one another. The proposal was a response to a Working Group of Commercial Energy Firms (WGCEF) petition seeking relief from the aggregation provisions of the position limits rule.

Position limits is another area where there has been close international coordination. The G-20 leaders endorsed an International Organization of Securities Commissions (IOSCO) report last November noting that market regulators should use position management regimes, including position limits, to prevent market abuses. The European Commission has proposed such a position management regime to the European Parliament.

Cross-border Application of Dodd-Frank's Swaps Reforms

The Dodd-Frank Act states in Section 722(d) that swaps reforms shall apply to activities outside the United States if those activities have "a direct and significant connection with activities in, or effect on, commerce" of the United States.

CFTC staff will soon be recommending to the Commission to publish for public comment a release on the cross-border application of swaps market reforms. It will consist of interpretive guidance on how these reforms apply to cross-border swap activities. It also will include an overview as to when overseas swaps market participants, including swap dealers, can comply with Dodd-Frank reforms through reliance on comparable and comprehensive foreign regulatory regimes, or what we call "substituted compliance."

There is further work to be done on the CFTC cross-border release, but the key elements of the staff recommendations are likely to include:

- First, when a foreign entity transacts in more than a de minimis level of U.S. facing swap dealing activity, the entity would register under the CFTC's recently completed swap dealer registration rules.

- Second, the release will address what it means to be a U.S. facing transaction. I believe this must include transactions not only with persons or entities operating in the United States, but also with their overseas branches. In the midst of a default or a crisis, there is no satisfactory way to really separate the risk of a bank and its branches. Likewise, I believe this must include transactions with overseas affiliates that are guaranteed by a U.S. entity, as well as the overseas affiliates operating as conduits for a U.S. entity's swap activity.

- Third, based on input the Commission has received from market participants, the staff recommendations will include a tiered approach for requirements for overseas swap dealers. Some requirements would be considered entity-level, such as for capital, risk management and recordkeeping. Some requirements would be considered transaction-level, such as clearing, margin, real-time public reporting, trade execution and sales practices.

- Fourth, such entity-level requirements would apply to all registered swap dealers, but in certain circumstances, overseas swap dealers could comply with these requirements through substituted compliance.

- Fifth, such transaction-level requirements would apply to all U.S. facing transactions, but for certain transactions between an overseas swap dealer (including a foreign swap dealer that is an affiliate of a U.S. person) and counterparties not guaranteed by or operating as conduits for U.S. entities, Dodd-Frank may not apply. For example, this would be the case for a transaction between a foreign swap dealer and a foreign insurance company not guaranteed by a U.S. person.

In putting together this release, we've already benefitted from significant input from market participants. Throughout our nearly 60 rule proposals, we've consistently asked for input on the cross-border application of swaps reforms.

Commenters generally say they support reform. But in what some of them call a "clarification," we find familiar narratives of the past as to why many swaps transactions or swap dealers should not be regulated. Some commenters have expressed the view that if a transaction is done offshore, it should not come under

Dodd-Frank. Others contend that as long as an offshore dealer is regulated in some capacity elsewhere, many of the Dodd-Frank regulations applicable to swap dealers should not apply.

The law, the nature of modern finance, and the experiences leading up to the 2008 crisis, as well as the reminder of the last two weeks, strongly suggest this would be a retreat from much-needed reform.

When Congress and the Administration came together to draft the Dodd-Frank Act, they recognized the lessons of the past when they expressly set up a comprehensive regulatory approach specific to swap dealers. They were well aware of the nature of modern finance: financial institutions commonly set up hundreds if not thousands of "legal entities" around the globe with a multitude of affiliate relationships. When one affiliate of a large, international financial group has problems, it's accepted in the markets that this will infect the rest of the group.

This happened with AIG, Lehman Brothers, Citigroup, Bear Stearns and Long-Term Capital Management.

Implementation Phasing

As we move on from the rule-writing process, a critical part of our agenda is working with market participants on phased implementation of these reforms. We have reached out broadly on this topic to get public input. Last spring, we published a concepts document as a guide for commenters, held a two-day, public roundtable with the SEC, and received nearly 300 comments. Last year, the Commission proposed two rules on implementation phasing relating to the swap clearing and trading mandates and the swap trading documentation and margin requirements for uncleared swaps. We have received very constructive public feedback and hope to finalize the proposed compliance schedules in the next few months.

In addition to these proposals, the Commission has included phased compliance schedules in many of our rules. For example, both the data and real-time reporting rules, which were finalized this past December, include phased compliance. The first required reporting will be this summer for interest rate and currency swaps. Other commodities have until later this fall. Additional time delays for reporting were permitted depending upon asset class, contract participant and in the early phases of implementation.

The CFTC will continue looking at appropriate timing for compliance, which balances the desire to protect the public while providing adequate time for industry to comply with reforms.

Resources

Confidence in the futures and swaps markets is dependent upon a well-funded regulator. The CFTC is a good investment of taxpayer dollars. This hardworking staff of 710 is just 10 percent more than what we had in the 1990s though the futures market has grown fivefold. The CFTC also will soon be responsible for the swaps market – eight times bigger than the futures market.

Picture the NFL expanding eightfold to play more than 100 football games in a weekend, leaving just one referee per game, and, in some cases, no referee. Imagine the mayhem on the field, the resulting injuries to players, and the loss of confidence fans would have in the integrity of the game.

Market participants depend on the credibility and transparency of well-regulated U.S. futures and swaps markets. Without sufficient funding for the

CFTC, the nation cannot be assured that the agency can adequately oversee these markets.

Conclusion

Nearly four years after the financial crisis and two years since the passage of Dodd-Frank, it's critical that we fully implement the historic reforms of the law. It's critical that we do not retreat from reforms that will bring greater transparency and competition to the swaps market, lower costs for companies and their customers, and protect the public from the risks of these international markets.

In 2008, the financial system and the financial regulatory system failed. The crisis plunged the United States into the worst recession since the Great Depression with eight million Americans losing their jobs, millions of families losing their homes and thousands of small businesses closing their doors. The financial storms continue to reverberate with the debt crisis in Europe affecting the economic prospects of people around the globe.

The CFTC has made significant progress implementing reform having largely finished the rule proposals, and now having completed well over half of the final rules.

We are on schedule to complete the remaining reforms this year, but until we do, the public is not fully protected.