Testimony Regarding Reducing Risks and Improving Oversight in the OTC Credit Derivatives Market

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Chairman Reed, Ranking Member Allard, and Members of the Subcommittee:

I am pleased to have the opportunity to testify today regarding the Securities and Exchange Commission's efforts to encourage sound risk management practices and enhance the infrastructure in the over-the-counter ("OTC") credit derivatives market. You are all well aware of The Clearing Corporation's recent announcement to establish a central counterparty ("CCP") for credit default swaps ("CDS"). This is an important step in reducing systemic risk and achieving greater operational efficiency in the market.

The Commission has extensive experience with the benefits of centralized clearance and settlement systems for securities. Over the years, these systemically important systems have reduced costs of securities trading, and have been carefully structured to manage and reduce counterparty risk.

Congress recognized the importance of a strong national clearance and settlement system for securities with the Securities Acts Amendments of 1975 ("1975 Amendments") to the Securities Exchange Act of 1934 ("Exchange Act"). In the 1975 Amendments, Congress directed the Commission to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions. The 1975 Amendments also provided the Commission with regulatory authority over securities clearing agencies. As the financial markets evolved, that directive was revised by the Market Reform Act of 1990 to reflect the interdependence of options, futures, and equity markets that trade products involving securities or security indices.

The 1975 Amendments were in direct response to the Paperwork Crisis of the late 1960's that nearly brought the securities industry to a standstill and directly or indirectly resulted in the failure of large numbers of broker-dealers. The causes of the Paperwork Crisis are similar to the issues that we have been trying to resolve in the OTC derivatives market. The crisis resulted from a combination of sharply increased volume and inattention to securities processing. As a result, the industry's clearance and settlement procedures were inefficient and lacked automation, thus implicating the finances of the securities firms. Today, almost forty years later, increasing automation in the processing of OTC derivatives transactions is one of the key goals of the OTC confirmations initiative, in which the Commission is a very active participant, called the "Fed 14 Initiative."

As I mentioned earlier, the 1975 Amendments require securities clearing agencies to register with the Commission pursuant to Section 17A(b) of the Exchange Act and Rule 17Ab2-1 thereunder, or obtain an exemption from registration to carry out certain limited clearing agency functions.[1] The Commission has authority to register entities that provide securities clearance and settlement services as clearing agencies or grant them an exemption from registration. This authority is the key component of the Commission's regulation of these entities. An exemption from registration as a clearing agency depends on ongoing compliance with conditions consistent with the principles of Section 17A and the goals of the Commission's regulatory oversight. Exempt clearing agencies are not required to file proposed rule changes.

Securities clearing agencies undergo a rigorous application process. The process enables the Commission to determine whether the applicant can process securities transactions and minimize risk. The Commission's determinations involve several areas that we believe have led to the U.S. securities clearance and settlement system's ability to reduce risk, increase operating efficiency, and operate at relatively low cost to the financial markets. The Commission's statutory mandate also reflects key findings by Congress that serve as principles to ensure a safe and secure market infrastructure.

The findings are as follows:

(1) The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.
(2) Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.
(3) New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.
(4) The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.[2]

The Commission uses its broad authority to examine registered and exempt clearing agencies for compliance with the federal securities laws and to verify that registered clearing agencies, which are self-regulatory organizations, comply with their own rules. Exempt clearing agencies are examined for compliance with the conditions of their exemptions. The Commission

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[1] Under Section 17A of the Exchange Act the Commission is authorized to grant conditional or unconditional exemptions from the provisions of Section 17A if it determines such an exemption is consistent with the public interest, the protection of investors, and the provisions of Section 17A (including the prompt and accurate clearance and settlement of securities transactions and the safeguarding of securities and funds).

[2] 15 U.S.C. 78q-1(a)(1)(A)-(D).

approves the rules of registered clearing agencies by publishing the rules for comment and approving them only after considering their compliance with the requirements of the Act and the comments received from the public.

Over the past 33 years, the SEC has not only registered securities clearing agencies, but also has worked with the industry and other regulators to improve the infrastructure and respond to challenges. For example, following the 1987 Market Break, the Commission convened a Task Force of industry participants to develop recommendations on ways to improve the clearance and settlement of securities transactions. The Task Force made several important recommendations, including that the SEC shorten the settlement cycle from five days to three. During the same period, the SEC worked with the securities industry to ensure that the U.S. clearance and settlement system exceeded the standards set forth by the Group of Thirty in 1989.

In 2001 and 2004, the SEC was at the forefront of establishing higher standards to reflect the complexities of an ever increasing global and interconnected securities market. The SEC did this by helping to draft the Committee on Payment and Settlement Systems and International Organization of Securities Commission ("CPSS-IOSCO") reports called the Recommendations for Securities Settlement Systems and Recommendations for Central Counterparties. These reports establish today's standards on how a clearance and settlement system must operate.

After the September 11th terrorist attacks, the Commission, together with the Federal Reserve Board and the Office of the Comptroller of the Currency, undertook a study of the lessons learned by the financial markets. This has led to the establishment of business continuity and recovery goals for the core clearing organizations and significant participants in our financial marketplace.

For almost two decades, the SEC has been working with the industry to implement straight-through processing ("STP") throughout the securities marketplace. STP has been described "as the seamless integration of systems and processes to automate the trade process from end-to-end – trade execution, confirmation, and settlement – without manual intervention or the re-keying of data."[3] In more practical terms, achieving STP would mean greater efficiency, lower costs, and enhanced business continuity because the entire process would be automated. Today, all transactions on the largest U.S. equity exchanges are matched immediately so that there are no confirmation backlogs or lost data. In our view, our efforts to improve and automate the processing of equity transactions dating back to the early 1990s have helped market participants to have a better understanding of the need to improve the processing for OTC derivative instruments today.

Next, I'd like to share with you a quote from a report on clearance and settlement published by the International Securities Market Association in 1999:

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[3] "STP Glossary," prepared by the Securities Industry Financial Markets Association and available at http://www.sifma.org/services/techops/stp/other/STPGlossaryv3.0.xls.

> *These days, anybody can replicate the contracts an exchange can offer; anybody can set up the hardware to become an electronic exchange. Maybe the only way left to differentiate yourself is by really good clearing and settlement.*

Strong clearance and settlement systems are the backbone of the success of the U.S. securities market. They are, and must continue to be, strong, resilient, flexible, and cost efficient. Their success, which is world renowned, relies on a dedicated core of exchanges, clearing agencies, and hundreds of banks, brokerage firms, and companies working together, while still remaining competitive. The degree of interdependence is staggering.

Today, our securities markets are considered the best in the world, so it should be no surprise that the clearing agencies supporting those markets are also considered among the world's best. Some of the clearing agencies regulated by the Commission are subsidiaries of the Depository Trust and Clearing Corporation ("DTCC"). These clearing agencies provide clearing, settlement, and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, and money market instruments. The Depository Trust Company, a clearing agency registered with the Commission, and a subsidiary of DTCC, provides custody and asset servicing for 3.5 million securities issues from the United States and 110 other countries and territories, valued at $40 trillion. In 2007, the clearing agencies registered with the Commission that are DTCC subsidiaries settled more than $1.86 quadrillion in securities transactions. Thanks to netting, transaction settlement obligations were reduced by 98 percent.

In addition to the Commission's experience with clearance and settlement for securities, the Commission has a strong interest in the clearance and settlement of CDSs because of its oversight of the largest internationally active U.S. securities firms through its voluntary consolidated supervised entities ("CSE") program. Each of the CSE firms plays a significant role in the OTC derivatives market. Through the CSE program, the Commission oversees not only the U.S.-registered broker-dealer, but also supervises the holding company and all affiliates on a consolidated basis, including unregulated entities such as derivatives dealers. These prudential supervision activities provide a window into broader market trends involving credit derivatives that has proven useful in understanding the potential impact of these instruments on the broader financial system. The Commission also has oversight of public reporting companies under the Exchange Act that are users and sellers of credit derivatives.

In particular, the CSEs make active markets in credit derivatives and rely on them significantly to hedge and take proprietary positions. This trading generates significant market, credit, and operational risk for the CSEs. The buying and selling of default protection creates short and long exposures – market risk – to the index, entity, or asset referenced in the CDS contract. At the same time, the buying and selling of default protection creates potential credit risk exposure to trading counterparties. Given that the CSEs execute hundreds of CDS agreements a day, the risk management and control resources required to do so in a prudent way are substantial. A significant part of the Commission's CSE supervision program is dedicated to monitoring and assessing CSEs' market and credit risk exposures arising from such trading and dealing activities.

In terms of operational risk, credit derivatives pose unique challenges. From the perspective of a consolidated supervisor, one challenge is that CSE firms' efforts to reduce market and credit risk exposures can often serve to *increase* the operational risk borne by the firm. This is because the easiest way to reduce risk often is to enter into a new, offsetting trade, rather than unwind an existing one. This means a new confirm, a new reference entity, a new counterparty, a new position to be booked and reconciled and mapped to the myriad of risk and control systems – all in the service of reducing risk. This paradox, in part, motivates the SEC's interest in participating in initiatives focused on improving the operational efficiency of credit derivatives trading.

Another important motivating factor stems from the Commission's review of the events leading to the collapse of Bear Stearns, which included a significant number of its derivatives counterparties novating their trades to other dealers. Whether done out of an abundance of caution or with less benign intent, the dramatic increase in novations served to generate negative market perceptions of Bear Stearns' health, feeding rumors. At the same time, a larger number of counterparties began disputing margin call amounts on derivatives trades, adding further to the negative perceptions. Bear Stearns' ability to cope with the operational demands of these developments stressed systems and personnel internally. Greater operational efficiency with regards to credit derivatives may have materially mitigated some of these impacts.

As Erik Sirri, the Director of the Division of Trading and Markets, recently testified before this subcommittee, since the events of mid-March that culminated in the sale of Bear Stearns, the SEC has revised its analysis of the adequacy of capital and liquidity and is currently directing investment banks supervised under the voluntary CSE program to undertake additional stress testing at the holding company level. The Commission has also engaged both international and domestic regulators in a cooperative manner to share information and to discuss the broader policy implications of these events. Strengthening CDS infrastructure would reduce risks in dealing with firms under stress.

As I mentioned earlier, the SEC is participating in the Federal Reserve initiative to improve the confirmation backlog of OTC derivatives, which has made progress over the last several years, including an 85 percent reduction in unconfirmed trades. The CSEs are some of the most active market participants in these markets, and have taken this opportunity to enhance their operational effectiveness. While supporting and in many cases driving the search for a more permanent solution, in the short-term the firms are seeking to reduce gross exposures by tearing-up, or netting, offsetting positions. They are doing so both bilaterally with trading partners as well as multilaterally through vendor-provided solutions. At the moment, this is easiest to do with index trades.

The SEC and other regulators, such as the Federal Reserve, are discussing whether and how the market for OTC derivatives contracts might benefit from a central clearing party for the CDS market and further elimination of confirmation backlog, among other things. Senior Commission staff represented the SEC at a June 9th meeting addressing these topics hosted by the Federal Reserve Bank of New York. The dealer community is also moving forward on an initiative to improve settlement of OTC contracts, a process in which the SEC is also participating. A CCP, such as a clearing house, ideally would be sized to handle spikes in transaction volume, would promote certainty of contract settlement and thereby minimize risk, as well as reduce the negative effects of misinformation and rumors that may occur during high volume periods.

Looking forward to the contemplated CCP for CDSs, one paramount concern would be the ability of the CCP to implement sound risk management practices. This is because a CCP concentrates risk. A CCP typically "novates" bilateral trades so that it assumes any counterparty risks. Novation allows the CCP to enter into separate contractual arrangements with both counterparties – becoming buyer to one and seller to the other. As part of its risk management, a CCP may subject novated contracts to initial and variation margin requirements or establish a clearing fund. The CCP also may implement a loss sharing arrangement among its participants to respond to a participant insolvency or default. Thus, a CCP can serve a valuable function in reducing systemic risk by preventing the failure of a single market participant from having a disproportionate effect on the overall market. A CCP also may facilitate the offset and netting of obligations arising under contracts that are cleared through the system.

While providing a number of potential benefits, a CCP for credit derivatives or any OTC derivatives contracts is subject to substantial challenges. This is because the markets for OTC derivatives are generally less liquid than markets for exchange-traded instruments. As a result, the traditional procedures for a CCP to handle a default may not be as effective for these products. The traditional procedures for handling a default, which are used by CCPs for most exchange-traded derivatives, call for the CCP to terminate all of its contracts with the defaulting participant, and promptly enter the market and replace the contracts. This will hedge against further losses on the open positions created by termination of the defaulter's contracts. But if the markets for the contracts cleared by the CCP are illiquid or under stress, entering the market may induce adverse price movements, especially if the defaulting participant's positions are large. Consequently, the application of traditional default procedures to illiquid OTC contracts may entail significant risk to the CCP.

Accordingly, one should not view a CCP as a silver bullet for concerns about the management of exposures related to credit derivatives. Even with a CCP, preventing a systemic risk buildup would require dealers and other market participants to manage their remaining bilateral exposures effectively and the dealers' management of their bilateral exposures would require ongoing supervisory oversight. Nonetheless, developing a CCP for clearing CDSs would be an important step in accomplishing this goal.

The current plan from The Clearing Corporation to create a CCP, as we understand it, relates only to post-trade operations. These operations, as discussed above, would mitigate some forms of credit risk. The trade is executed off-exchange, *i.e.*, in the OTC market, when an agreement is reached between two individual counterparties.

It is not uncommon for derivative contracts that are initially developed in the OTC market to become exchange-traded, as the market for the product matures. While the contracts traded in the OTC market are subject to individual negotiation (other than price and quantity), an exchange creates a market for a standardized form of the contract that is not subject to individual negotiation (other than price and quantity). These exchange-traded contracts typically coexist with the OTC contracts. In this regard, we note that last year the Commission approved a proposal by the Chicago Board Options Exchange to list and trade Credit Default Options ("CDOs") and Credit Default Basket Options.[4] The CDOs are modeled after CDSs and structured as binary call options[5] that settle in cash based on confirmation of one or more specified adverse credit developments (such as payment default) involving obligation(s) referenced in the CDO, such as a debt security.

Exchange trading of credit derivatives would add both pre- and post-trade transparency to the market which could add credibility to the pricing of credit derivatives. Exchange trading could also reduce liquidity risk by providing a centralized market, which would allow participants to better initiate and close out positions efficiently and at the best available prices.

As you can see, developments in the derivatives space pose significant operational and regulatory challenges, which will have to be addressed as this market matures. Again, thank you for this opportunity to discuss these important issues. I am happy to take your questions.

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[4] See Exchange Act Release No. 55871 and Exchange Act Release No. 56275 (August 17, 2007), 72 FR 47097 (August 22, 2007) [File No. SR-CBOE-2007-26] (order approving the listing and trading of credit default basket options).

[5] A "binary call option" is an option contract that will pay the contract holder a fixed amount upon exercise.