

**Testimony of Robert Pickel
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Before the
US Senate Committee on Agriculture, Nutrition and Forestry
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Chairwoman Stabenow, Ranking Member Roberts and Members of the Committee:

Thank you for the opportunity to testify today. In the two years since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, significant progress has been made in three important areas in building a safer, more transparent over-the-counter (OTC) derivatives market and a more robust financial system.

First, as discussed in greater detail below, OTC derivatives market participants have continued to work, in advance of the onset of the new regulatory framework, toward the goals of reducing counterparty credit risk and increasing regulatory transparency.

Second, US policymakers over the past two years have made significant progress in defining and implementing the new regulatory framework. The scale and scope of this undertaking is considerable, and within that context it is clear that much has been achieved.

Third, progress has also been made on an international level in understanding the need for regulatory frameworks to be consistent and coordinated across jurisdictions. This is essential to ensure a level playing field for financial markets and financial institutions and to avoid regulatory arbitrage.

While this progress is both real and significant, it is clear that in certain respects the process of implementing the new regulatory framework envisioned by Dodd-Frank has been problematic. It has, for example, taken longer than initially expected. Many rules and regulations have yet to be finalized. The inter-relationship of Dodd-Frank related regulations needs to be considered and assessed to avoid contradictory rulemakings. Similarly, the set of Dodd-Frank rules in the US needs to be calibrated against similar frameworks in other jurisdictions.

All of these issues are causing considerable confusion and uncertainty in the financial markets. This confusion imposes both direct and indirect costs on the financial institutions that are required to comply with them. The direct costs include the time and resources spent trying to understand and implement them. The indirect costs include the foregone financial activity to which firms might otherwise allocate their resources. Both of these costs have a real economic impact. And, regardless of the significant resources being devoted to compliance, it is highly likely that the industry, market utilities (e.g., clearinghouses and repositories) and the regulators will be unable to fully implement many provisions of the law within the requisite timeframe.

Two years after the passage of the Dodd-Frank Act, it is fair to step back and ask how and where we could accelerate its implementation. ISDA and our members would suggest four concrete steps that could lead to the most progress in the shortest timeframe with the fewest disruptions.

- First, the finalization and implementation of rulemakings should be prioritized to focus on those that are most systemically important;
- Second, the most systemically important rulemakings should be analyzed and assessed to ensure that their implementation is properly sequenced;
- Third, after the sequencing is completed, US regulators should work with their international counterparts to ensure consistency in substance and timing of the new regulations.
- Fourth, the agencies need to engage in a fulsome cost-benefit analysis that considers the impact of the new framework on financial institutions, corporations, market liquidity, and the economy.

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I would like to address each of my points in more detail. But before I do, it's important to state clearly: The International Swaps and Derivatives Association squarely supports financial regulatory reform that includes measures such as enhanced regulatory transparency and centralized clearing of standardized trades. What's more, we have worked actively and engaged constructively with policymakers in the US and around the world to achieve this goal.

This, indeed, is our mission: to foster safe and efficient derivatives markets for all users of derivatives products. ISDA has, for example, helped to significantly reduce credit and legal risk by developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions. The Association has also been a leader in promoting sound risk management practices and processes.

Today, ISDA has more than 830 members from 59 countries on six continents. These members include a broad range of OTC derivatives market participants: asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers, as well as global, international and regional banks.

About one-third of those members are based in the US, of which nearly half are end-users. This demonstrates two important points. First, the US is an important center of global derivatives activity, a fact borne out by statistics from the Bank for International Settlements that indicate that about a quarter of global interest rate derivatives activity occurs in the US. ISDA's own research indicates that virtually all Fortune 500 companies use derivatives to manage their risks. Second, ISDA's membership is diverse and includes a variety of market participants. 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.

In summary, derivatives are an important part of the US financial system and they play an important role in the real economy for US companies.

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Because of the important role they play, international policymakers recognized during and since the financial crisis the importance of developing and implementing an appropriate regulatory framework for derivatives activity. Their fundamental policy approach, which is reflected in the Dodd-Frank Act, was articulated in the G-20 Pittsburgh Communiqué, which stated: “All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by year end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”

There are three major principles related to systemic risk espoused in the statement:

- Central clearing of standardized swaps;
- Trade reporting of all swaps; and
- Higher capital requirements for uncleared swaps.

While capital requirements are extremely important, they are principally the responsibility of the BIS Basel Committee and national banking supervisors. The first two principles, however, (central clearing and trade reporting) are clearly key drivers of the Dodd-Frank legislative effort. They are important steps in addressing and potentially mitigating systemic risk. Clearing can reduce counterparty credit risk by putting a well-capitalized institution able to absorb risk between derivatives counterparties. Trade reporting increases regulatory transparency, which enables supervisors to see and analyze exposures that may build up in the system.

In the years leading up to and since the passage of the Dodd-Frank Act, ISDA, the major dealers, buy-side institutions and other industry associations have worked collaboratively with global regulatory supervisors in both of these areas. The work begun as part of the “Voluntary Commitment” process overseen by the Federal Reserve Bank of New York serves as the foundation for the continuing progress made today.

We note that, currently, in advance of any legally-required clearing, over 50% of the interest rate swaps market is centrally cleared. More than 90% of new eligible credit and interest rate derivatives transacted between clearing house members are submitted for centrally clearing. The volume of uncleared interest rate swaps has declined 40% between 2007 and 2011.

ISDA and market participants have also established trade repositories for the different OTC derivatives asset classes. Trade repositories collect and maintain a database of OTC derivatives transactions, such databases being available to regulators at any time. As noted, they can play an important role in improving regulatory transparency by providing an unprecedented level of market and firm-wide risk exposures to the appropriate supervisors and regulators. ISDA has helped to establish repositories for interest rate, credit, equity and commodity swaps and the industry is also establishing one for foreign exchange swaps.

In these and other ways, we are demonstrating our long-standing commitment to build robust, stable financial markets. Our work is not done yet. Further progress lies ahead as the new regulatory framework for derivatives is implemented.

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Progress in these areas is closely tied to the development and implementation of the new rules required under Dodd-Frank. We believe that, in order to achieve the most gains in the shortest timeframe with the fewest disruptions, that the rulemakings should be prioritized according to their systemic importance, that they be reviewed to ensure they are sequenced appropriately and that they are then harmonized with rules of other key jurisdictions. Each of these points is discussed in more detail below.

Prioritize Rulemakings

As noted above, laws, rules and regulations related to central clearing and trade reporting have the most important implications in terms of systemic risk reduction. It is therefore essential that resources be focused on these areas to ensure their implementation at the earliest possible date.

In particular, it is of primary importance that regulators first get the information they need to further implement Title VII of the Dodd-Frank Act through functioning trade repositories and effective regulatory reporting and related recordkeeping.

Functioning SDRs and effective regulatory reporting of swap transactions are prerequisites to an orderly transition to the Title VII regime. Once it begins to compile data across markets, entities and transactions, the CFTC will be well-positioned to determine which types or classes of transactions should become subject to mandatory clearing and in what order and how to implement and monitor compliance with business conduct and other swap dealer rules. As stated by the Financial Stability Board's OTC Derivatives Working Group in a recent report, "authorities need better data on liquidity to facilitate the evaluation of suitability of products for central clearing."

Following this stage, regulators could then turn to the second stage: phasing-in of mandatory clearing (in the same order as that suggested above for reporting) and mandatory compliance with margin and capital rules.

After the first two stages – which focus on systemic risk mitigation -- are complete, attention could then turn to issues of non-systemic importance, such as execution requirements and standards governing the business relationship between counterparties

Appropriate Sequencing of Rulemakings and Implementation

As the most important areas of rulemaking are prioritized, it will also be important to make sure these rulemakings occur in the appropriate sequence. There is an urgent need to avoid a rule-making and implementation schedule that contain contradictory or confusing deadlines. At the

least, a more detailed and realistic timeline for both final and proposed rulemakings would assist in the planning and implantation process, by, among other things, allow market participants to allocate resources in the most efficient and effective manner.

For example, based solely on the current compliance schedule for CFTC rules that have been finalized to date, swap dealers and their counterparties may need to amend their swap trading relationship documentation three separate times between late September and the end of this year. In addition, unless compliance dates for rules that have been proposed (but not yet issued and published in final form) by the Commission are coordinated, swap dealers and their counterparties will be required to further amend the full inventory of their swap trading relationship documentation several times in 2013. This would significantly increase operational and legal risks in addition to raising costs and confusion for end-users. This is one of the numerous examples of the potential problems that could be caused by the current sequencing of rules.

Separately, many firms are currently facing structural decisions related to the implications of registering as “swap dealers,” without knowing the details or requirements of such a decision. This problem is exacerbated further by the extraterritorial or cross-border guidance discussed in greater detail below, which, while only proposed, will have significant implications for firms doing business globally.

We recommend that, instead of “rolling implementation” of regulatory requirements, the regulators allow for a “look back” period once the full panoply of regulations are finalized, but not yet effective. That will allow for an assessment of the entire regulatory regime and for market participants and regulators to see how these rules interact. Such a review is vital to ensure the continued competitiveness and liquidity of the US markets.

International Harmonization

The third step that is important to ensure a timely, efficient and successful implementation of the guiding principles behind the G20 statement and the Dodd-Frank Act is a consistent, harmonized regulatory framework across jurisdictions. The G-20 vision of a global market transitioning cooperatively to common regulation may stand, fall or be delayed by US regulators’ position on extraterritorial application of the US version of that vision.

The G20 commitment was to “implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage.” This is a vitally important consideration in the development of a robust and globally consistent regulatory framework.

Today, however, there are serious concerns about the differences in the substance and the timing of rules between key regulatory jurisdictions. There is a great deal of uncertainty among market participants with respect to whether, and how, to implement a new regulatory framework that may duplicate or conflict with that of their parent country. And perhaps more importantly, there are concerns about whether level playing fields will be maintained.

Recently, the CFTC released its proposed interpretive guidance and policy statement regarding the cross-border application of the swaps provisions of the Dodd-Frank Act (“ET Guidance”). While the proposed ET Guidance is a step forward in that it marks the beginning of the “official” public dialogue on the issue, it also raises significant concerns. These include inadequate coordination with the SEC on its companion cross-border release and with non-US regulators, an overly expansive interpretation of the extraterritorial application of Title VII, a vague approach to comparability determinations for non-US regulatory systems, lack of fair treatment of US market participants and the lack of any cost-benefit analysis for new rules.

Ultimately, these issues combine to threaten a level playing field by:

- imposing on US market participants a substantially earlier rollout of regulatory requirements which, rather than attracting customers, may by dint of added cost and complexity drive customers to foreign competitors not yet so burdened.
- subjecting the market as a whole to regulatory inconsistencies that require four pages of grid charts to fathom, and that are based on conflicting and shifting policy rationales.
- moving in advance of SEC clarification of its own extraterritorial jurisdiction, so creating the potential for inconsistency between the swap and security-based swap markets.

Separately, the CFTC’s choice of informal policymaking without cost-benefit analysis will in effect slight the public and the CFTC, by forfeiting the opportunity for appropriate, full review. Due to the important nature of this subject matter, this proposal should be subject to formal rulemaking.

As noted, this proposed guidance is extremely broad, covering the activities of anyone, anywhere doing business as, or with, a “US Person.” In the view of the CFTC, wherever a US person enters into a swap, Title VII applies. To be plain, if a US person, doing business overseas, were to enter into a swap with a non-US counterparty, even if neither were a swap dealer or major swap participant, numerous Title VII requirements would apply.

This regulatory regime proposed through the ET Guidance is unnecessarily complex and, in many instances inconsistent. The proposal segments the standards into “entity level” and “transaction level” requirements, the application of which may vary widely depending on an entity’s status. For example, the definition of “US person” includes an entity having a US person as a direct or indirect owner that is responsible for the entity’s liabilities. It is unclear if such definition captures simple owners or if the definition reaches owners with partner or guarantor liability. Yet a foreign affiliate guaranteed by a US person is not a US person under the Proposed Guidance. A non-US swap dealer affiliate of a US person that is not guaranteed by a US person is potentially entitled under the Proposed Guidance to substitute compliance with all entity-level requirements. An identically affiliated non-US swap dealer that is guaranteed by a US person may face special swap data reporting requirements, but otherwise also may be able to take advantage of substitute compliance.

This complexity extends to non-US persons that are unregistered counterparties guaranteed by US persons entering into transactions with non-US swap dealers or major swap participants.

Here, for example, the presence of a US guarantor of the non-swap dealer (who, of course, is responsible only for the liabilities of the counterparty) in a reversal of common regulatory logic subjects the guaranteed transactions to transaction level regulatory requirements even though the guarantor is not even a direct party to the transactions. However, such a guaranteed unregistered, non-US person in a transaction with another just like itself is free of these transaction level requirements. Arguably, there is some purpose for these distinctions, however, they are inconsistent with the G-20 goals of fair global regulatory uniformity.

The impact of the ET Guidance on non-US swap dealers doing business in the US is also likely to be adverse. Along with the ET Guidance, the CFTC proposes a 12-month exemption from many Title VII requirements for non-US swap dealers and major swap participants who register with the CFTC and submit a compliance plan indicating any comparability determinations that they will seek. The CFTC registration deadline is likely to be mid-September. Will regulation offering prospects of comparability be in place soon enough after that to allow time for CFTC review before expiration of the temporary exemption? We think that in many jurisdictions the answer is at best “maybe”. In Europe, for example, although a package of derivatives regulation known as EMIR is scheduled to come into effect in January 2013, that date is uncertain. A second package of regulation, known as MIFID II is not expected to come into force until 2015. MIFID II will then require some degree of individual nation implementation (and hence variability). MIFID II will reach areas of regulation that will be germane in a comparability analysis.

Hong Kong, as an example of another important market jurisdiction, is intending to pass its new derivatives legislation by the end of 2012. “Public consultation” on regulations is intended to begin at the same time. The calendar for Singapore is similar. Hong Kong and Singapore are leaders in G-20 implementation in Asia. Nonetheless, it is by no means clear that these jurisdictions will be able to show an adequate basis for comparability by some reasonable point in 2013.

This potential lack of comparability means that non-US firms doing business in the US may be subject to ambiguous and duplicative requirements for the foreseeable future.

Will the Commission find well-intentioned foreign regulation shaped to G-20 requirements sufficient? This is unclear. Will foreign regulators join in heightened cooperation with the CFTC? This is unknown. Will foreign jurisdictions wish to shape their regulations to the CFTC’s requirements? This is unlikely. We fear that the granular approach proposed by the CFTC for determining comparability will potentially force firms to comply with an overlapping multi-layered web of regulatory requirements.

In addition to the issues raised by disparate rules, the timing of final implementation is of significant concern. For example, even if the rules of all jurisdictions are closely aligned, business will migrate to jurisdictions implementing the new burdensome requirements on a more reasonable timeline and, once there, such business will be unlikely to return to the US in full force.

ISDA stresses that principles of restraint and regard for comity are vital in this context, with respect to non-US participants in US markets and with respect to the treatment of US participants

in non-US markets. Disadvantaging non-US institutions and their US subsidiaries, through divergent capital requirements or otherwise, discourages non-US investment in US subsidiaries, which will have negative consequences for the broader economy. Such divergent treatment also creates the potential for retaliatory measures between jurisdictions, further reducing liquidity and competitiveness and creating fertile ground for regulatory arbitrage. This could put US firms and US markets at a disadvantage, including by discouraging continued growth and participation by non-US firms in US financial markets, thereby concentrating risk and liquidity in far fewer dealers.

Duplicative rules will raise costs, ultimately impacting the real economy, while not serving any regulatory goal. Conflict between regulatory approaches will lead to regulatory arbitrage and competitive advantage based not on better strategic decisions or more effective resource allocation, but on government fiat.

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In conclusion, much progress has been made in our shared goal of reducing risk in and increasing the stability of the OTC derivatives markets. More work remains to be done, however, and we need to reach consensus on the most effective and efficient way to do this.

ISDA and our members believe that such an approach is feasible and desirable. It would be based on a prioritization of initiatives that most impact systemic risk; the appropriate sequencing of those initiatives; and international harmonization of those initiatives.