S. HRG. 112–680

IMPLEMENTING DERIVATIVES REFORM: REDUCING SYSTEMIC RISK AND IMPROVING MARKET OVERSIGHT

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE IMPLEMENTATION OF THE NEW DERIVATIVES RULES AND RESPONSIBILITIES OF THE CFTC AND SEC AS MANDATED UNDER TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

MAY 22, 2012

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C O N T E N T S

TUESDAY, MAY 22, 2012

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

IMPLEMENTING DERIVATIVES REFORM: REDUCING SYSTEMIC RISK AND IMPROVING MARKET OVERSIGHT

TUESDAY, MAY 22, 2012

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

The Committee met at 10:05 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I will call this hearing to order.

Today we will review the progress being made to reduce systemic risk and improve oversight of the derivatives market. But before we get to the main subject of this hearing, I want to make a few comments about recent news made by JPMorgan Chase.

The company's massive trading loss is a stark reminder of the financial crisis of 2008 and the necessity of Wall Street reform. Since the firm's May 10 conference call, my staff and Ranking Member Shelby's staff have jointly held briefings with regulators and a briefing with the company itself. Following these briefings I announced last week that I intend to call JPMorgan's CEO Jamie Dimon to testify before the Committee.

In calling for Mr. Dimon to testify, I expect him to inform the Committee of the details surrounding what has been reported to be a very complex trade. With today's hearing, our June 6th bank supervision hearing with other key regulators and Treasury, and the hearing with Mr. Dimon, the Committee is on its way to having a more complete understanding of the facts about the JPMorgan matter that will help us better oversee the implementation of Wall Street reform.

This trading loss has been a wakeup call for many opponents of Wall Street reform and the need to fully fund the agencies responsible for overseeing the swap trades that appear to be at the core of the firm's hedging strategy. It is my hope that all of my colleagues who expressed such alarm about this matter will now join Democrats in advocating full funding for our regulatory "cops on the beat" to address the very issues that some now suddenly seem so concerned about.

It is understandable that this high-profile trading loss has caused many to renew their interest in Wall Street reform, but as

Chairman, I have never taken my eye off the ball. That is why we are here today continuing our oversight responsibilities.

Much of the reaction to recent events has focused on other provisions of Wall Street reform, but what has gotten far less attention is the impact derivatives reform will most certainly have on reducing the likelihood that banks would want to engage in certain high-risk, complex swap transactions in the first place. Higher margin and capital requirements for uncleared swaps, increased clearing obligations, real-time reporting requirements, and new anti-fraud and anti-manipulation authorities included in Wall Street reform will reduce market risk and improve the integrity of swap trading between large financial firms.

Chairman Schapiro and Chairman Gensler, I commend you and your staffs for your tireless efforts implementing these new reforms, and I look forward to hearing from you today. As you continue your efforts, I urge your agencies to take a single, unified approach to regulating cross-border transactions and to integrate this approach into all your swap rules. Differences between your two sets of rules and implementation efforts should be minimized to improve compliance and limit costs. And efforts by the United States to promote harmonization abroad will be more challenging if we cannot harmonize efforts by our agencies here at home.

Last, I would like to apologize in advance to my colleagues, but I will need to excuse myself for a 10:30 markup in the Appropriations Committee for my MilCon-VA bill. Senator Merkley has graciously agreed to chair this hearing in my absence.

To reserve time for questions, opening statements will be limited to the Chair and Ranking Member. However, I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials.

I now turn to Senator Shelby for his opening remarks.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Since the passage of the Dodd-Frank Act, its proponents have repeatedly claimed that both consumers and our financial markets will benefit from the new law. We now know that both of those claims are false.

Since last year, Chairman Gary Gensler oversaw the largest consumer protection failure in the history of the CFTC. Under Chairman Gensler's watch, customers of MF Global had $1.6 billion of funds improperly taken from their accounts.

The first and most basic responsibility, I believe, Mr. Chairman, of the CFTC is to ensure that customer funds are not misappropriated. Yet, despite all the new authorities conferred on the CFTC by Dodd-Frank, the CFTC was still unable to fulfill this primary responsibility to MF Global customers.

The CFTC's failure is especially troubling here because the funds went missing during a time when it was well known that the firm was under severe financial stress, and the risk of misappropriation there was very high. Even more embarrassing for the CFTC is the fact that there were numerous CFTC officials onsite at the firm when the funds went missing.

While I am pleased to see that the MF Global trustee is making progress in returning funds to MF Global customers, Chairman Gensler nonetheless owes the public, I believe, a full accounting of how they failed to protect those customer assets in the first place.

Unfortunately, Chairman Gensler continues to recuse himself from all matters pertaining to MF Global, which effectively insulates him from congressional scrutiny. Mr. Chairman, I believe the public deserves more from their financial regulators. We need regulators who are willing to explain their actions rather than run for the hills. If there were regulatory failures, the responsible parties need to be held accountable for their actions, and they need to admit what happened.

Chairman Gensler's recusal has impeded Congress' ability to examine every facet of the MF Global failure. I hope that today Chairman Gensler will be more forthcoming about his involvement with MF Global so that Congress can finally begin to understand what role he played and how Congress should respond. I also hope that Chairman Gensler will be more forthcoming about his management of the CFTC's implement of Dodd-Frank.

Chairman Gensler and SEC Chairman Mary Schapiro have jointly created widespread uncertainty about the regulation of derivatives. According to a recent report, regulators have met only one-third of their Dodd-Frank rulemaking deadlines. And while there is no question that the rulewriting process mandated by Dodd-Frank makes it very difficult to meet some of the deadlines, the regulators share culpability here.

For example, although the CFTC and the SEC have proposed numerous new rules for derivatives, they have still not proposed rules that clarify the definition of a swap.

Let me repeat that. Almost 2 years after the passage of Dodd-Frank, giving the CFTC and the SEC joint jurisdiction over the swap markets, they have still not agreed on the definition of a swap. Yet somehow they finalized rules based upon swap activities defining and governing swap dealers and major swap participants. If market participants do not know which of their activities will fall under the swap definition, how can they be expected to know whether these activities will be subject to the patchwork of registration, recordkeeping, clearing, and trading rules? And if market participants do not know if their activities will cause them to be classified as a swap dealer or a major swap participant, how can they be expected to know when to submit comments?

This is just one example that I am bringing out here of how Dodd-Frank and its implementation have created unnecessary uncertainty in our markets. As the American economy continues to struggle with high unemployment, sluggish growth, and the fallout from the ongoing European crisis, the last thing I believe we need are self-inflicted wounds. This includes those inflicted by Congress, regulators, and most recently, poorly conceived trading and hedging activities in one of our largest banks.

Today's hearing presents here in the Banking Committee an opportunity to discuss all of these and how they can be avoided in the future, and I thank you for calling this hearing, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby.

Now I would like to briefly introduce our witnesses, neither of whom are strangers to this Committee. Chairman Mary Schapiro is the head of the U.S. Securities and Exchange Commission. Chairman Gary Gensler is the head of the Commodity Futures Trading Commission. We appreciate both of your taking time out of your schedules to be with us today.

Chairman Schapiro, please begin your testimony.

STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to testify regarding the Securities and Exchange Commission's ongoing implementation of Title VII of the Dodd-Frank Act.

As you know, Title VII creates an entirely new regulatory regime for over-the-counter derivatives and directs the Commission and the CFTC to write a number of rules necessary to implement it. Of course, Title VII is just one of the many areas ranging from credit rating agencies to private fund and municipal adviser registration, to specialized corporate disclosures where the SEC is charged with writing rules.

The SEC already has proposed or adopted rules for over three-fourths of the more than 90 provisions in the Dodd-Frank Act that mandate SEC rulemaking. Additionally, the SEC has finalized 14 of the more than 20 studies and reports that the Dodd-Frank Act directs us to complete. And the Commission has proposed almost all of the rules required by Title VII. We are continuing to work diligently to implement all provisions of Title VII as well as the many other rules we are charged with drafting and to coordinate implement with the CFTC and other domestic and foreign regulators.

Under the Dodd-Frank Act, regulatory authority over swaps is divided between the CFTC and the Commission. The law assigns the SEC the authority to regulate security-based swaps while the CFTC has primary regulatory authority over the bulk of the Title VII over-the-counter derivatives market called "swaps." Our rulemakings are designed to improve transparency, to reduce information asymmetries, and facilitate the centralized clearing of security-based swaps to reduce counterparty risk. They are also designed to enhance investor protection by increasing disclosure regarding security-based swap transactions and mitigating conflicts of interest. By promoting transparency, efficiency, and stability, this framework is intended to foster a more stable and competitive market.

In implementing Title VII, SEC staff is in regular contact with the staffs of the CFTC, the Federal Reserve Board, and other financial regulators. In particular, Commission staff has coordinated extensively with CFTC staff in the development of the definitional rules, including joint rules further defining key product terms, which we expect to finalize soon, and rules further defining categories of market participants, which we adopted last month. Although the timing and sequencing of the CFTC's and the SEC's rulemaking may vary, they are the subject of extensive interagency

discussions, and the objective of consistent and comparable requirements will continue to guide our efforts.

The Dodd-Frank Act also specifically requires that the SEC, the CFTC, and the prudential regulators "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards." Accordingly, the Commission is actively working with regulators abroad to address the regulation of OTC derivatives, encouraging foreign regulators to develop rules and standards complementary to our own.

The Commission expects to complete the last of the core elements of our proposal phase in the near term, in particular, rules related to the financial responsibility of security-based swap dealers and major security-based swap participants. The Commission is finalizing a policy statement regarding how the substantive requirements under Title VII within our jurisdiction will be put into effect. This policy statement will establish an appropriate and workable sequence and timeline for the implementation of these rules.

As a practical matter, certain rules will need to go into effect before others can be implemented, and market participants will need a reasonable, but not excessive, period of time in which to comply with the new rules. This statement will let market participants know the Commission's expectations regarding the ordering of the compliance dates for various rules. Relevant international implementation issues will also be addressed in the single proposal.

Finally, your invitation letter requested that I address recent trading losses reported by JPMorgan Chase. Our best information is that the trading activities in question took place in the bank in London and perhaps in other affiliates, but not in the broker-dealer that is directly supervised by the SEC. Although the Commission does not discuss investigations publicly, I can say that in circumstances of this nature where the activity does not appear to have occurred in one of our regulated entities, the SEC would be primarily interested in and focused on the appropriateness and completeness of the entity's financial reporting and other public disclosures.

In conclusion, as we continue to implement Title VII, we look forward to continuing to work closely with Congress, our fellow regulators both at home and abroad, and members of the public. Thank you for the opportunity to share our progress on the implementation of Title VII, and I will, of course, be happy to answer any questions.

Chairman JOHNSON. Thank you.

Chairman Gensler, please begin your testimony.

STATEMENT OF GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of this Committee. I am pleased to testify along with SEC Chairman Schapiro. Today I am going to speak to the three topics of your invitation letter: first, where is the CFTC on swaps market reform; second, the CFTC's role in overseeing markets for credit derivative products such as those traded by JPMorgan Chase's Chief Investment Office; and, third, international progress on swaps reform and related issues of cross-bor-

der application. I also welcome Ranking Member Shelby's questions and look forward to chatting about that in public, as I would in private with any of the Members.

The CFTC is a small agency that is tasked with overseeing the futures markets and now, with passage of Dodd-Frank, a market nearly 8 times larger, the swaps market. Given these new responsibilities, we are significantly underfunded, but you have heard me say that before.

Our market oversight critically relies on market participants foremost complying with the laws and related rules and then the self-regulatory organizations, like the CME and the National Futures Association, that provide the first line of oversight. But in addition to that, we do rely on promulgating and implementing rules, and in that context, the CFTC has completed 33 swaps market reforms to date. We have just under 20 to go.

What do they do? They bring transparency to this marketplace; second, they lower risk through something called "central clearing of standardized swaps"; and, third, lower risk by comprehensively regulating the dealers.

We are on track to finish the reforms this year, but it is still very much standing up, and we are also giving the market time to phase in implementation to lower the costs and burdens on this very significant transition.

To increase market transparency, we have completed eight key reforms, including real-time reporting to the public and to regulators that will begin later this summer. On clearing, we finalized risk management and will soon seek public comment on which contracts themselves would be under what was called "the clearing mandate."

To promote market integrity, we have completed strong anti-fraud and anti-manipulation rules as well as aggregation position limits, and we are looking soon to finalize the end-user exception.

To lower risk of the swap dealers posed to the economy at large, we have completed rules requiring robust sales practices and risk management in a joint rule with the SEC on the further definition of the words "swap dealer" and "securities-based swap dealer." All of this is still, though, pending because it has to relate to us finalizing the further definition of the terms "swap" and "securities-based swap."

It is essential that the two Commissions move forward expeditiously to finalize this rule, and I am glad to say that both Commissions now have a draft of this rule that has been worked out through staff, and hopefully we will be able to finalize this in the near term.

We have made significant progress as well working with domestic and foreign regulators to bring a consistent approach to swaps market reform, and though not identical, Europe, Japan, and Canada now all have made real progress legislatively and now in rulewriting to bring similar reform. And, in particular, I want to say we are working on a consistent approach to global margin for uncleared swaps. It is important for a lot of reasons, but let me note one reason is that the CFTC proposed a rule that did not require financial end users to post margin, and we are advocating the

same globally. I just wanted to make sure people know that in the end-user community.

The Commission is also working on a balanced approach to cross-border application of swaps reform. I think Congress was guided by the experience of AIG with its London affiliate—well, actually it was a London branch—Lehman Brothers, Citigroup, Bear Stearns, and even Long-Term Capital Management, when it applies reforms to transactions that might be booked offshore but nonetheless have a direct and significant effect on U.S. commerce and activities. That in essence is a stark reminder we got in the last 2 weeks when JPMorgan's trading losses were overseas from trades that lost multi-billions of dollars and the credit default swaps and indices on credit default swaps.

The CFTC's Division of Enforcement has opened an investigation related to credit derivative products traded by JPMorgan Chase's Chief Investment Office, and although I am unable to provide any specific information about a pending investigation, I will touch upon the Commission's role in overseeing these markets. The CFTC has oversight and clear anti-fraud and anti-manipulation authority regarding the trade of credit default swaps indices. We also oversee the clearinghouses that already clear some of these products. Starting this summer, there will be real-time reporting to the public. And later this year, but not yet, we envision the dealers themselves to begin to register and that trading will commence on swap execution facilities. So we are in the midst of implementation that will take still some time.

In conclusion, though we have made great progress in bringing common-sense reforms to the swaps market, promoting transparency and lowering risk, it is critical we complete these reforms for the protection of the public.

Thank you.

Chairman JOHNSON. I would like to thank both of our witnesses for their testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Chairman Gensler and Chairman Schapiro, what role did your agencies have in monitoring the swap trades at issue in the JPMorgan matter? And were any concerns raised about these trades at either of your agencies? What changes will the derivative reforms bring to the regulation of these types of trades? And what are the potential implications for the Volcker Rule?

Chairman Gensler, please start.

Mr. GENSLER. As I mentioned in more depth in my written remarks, we are in the midst of standing up a regime that will still take some time, but the credit default swap indices—these are parts of the products that reported in the press that JPMorgan Chase's Chief Investment Office was trading—already come under our completed anti-fraud and anti-manipulation regime, and the clearinghouses—three of them, actually—already clear credit default swap indices voluntarily. Later this year, we anticipate seeking public comment on actually having a clearing mandate so that more of these trades will come into the clearinghouse. Currently it is just dealers to dealers. Later this year, we will have a regime that I actually think dealers will start to register, but this bank

was not yet registered as a swap dealer because we do not yet have complete rules to make that a true being. And later this year or maybe into 2013, you will start to see the commencement of trading transparent markets. We are not trying to do this against a clock. We are trying to get it balanced. I know that Congress gave us 1 year to get the job done, and we are pushing on 2 years. I do think we need to get the job done to better protect the American public, but at the same time take in the 30,000 comments we have received.

You asked when did it come to our attention. With matters like this, I do not want to get into the specifics of an investigation, but as press reports have shown, these are credit default swap indices that are under our jurisdiction for anti-fraud and anti-manipulation and the clearinghouses we monitor on a very real-time daily basis for the completeness of the margin and the safety and soundness of the clearinghouses.

Chairman JOHNSON. Chairman Schapiro?

Ms. SCHAPIRO. Thank you, Mr. Chairman. To the best of our understanding, none of the transactions were held in or executed in the U.S. broker-dealer. The activity took place in the London branch of the OCC-regulated bank and in a London-based affiliate investment management unit. So the SEC did not have any direct oversight or knowledge of the transactions.

I would reiterate what Chairman Gensler said. If the Dodd-Frank rules had been in place when the activity was going on, these positions likely would have all been cleared. Some substantial majority were—or some substantial number were, but not all were cleared. They would have likely been exchange traded. They would have been reported to a swaps data repository, and there would have been detailed transparency to regulators and transparency to the public, and I would say under the SEC's proposed rules for reporting, we would have known the trading desk and the trader as well who put the positions on. The dealer would have been registered and subject to business conduct standards, and they would also operate under the new rules for enhanced prudential supervision for bank-holding companies with assets greater than $50 billion.

So I think there are a number of pieces that would be in place once all the proposals to implement Dodd-Frank are completed.

Chairman JOHNSON. Chairman Schapiro, can you commit to us that the SEC will issue the last of your proposed derivatives rules in the coming months and that you will prioritize within the SEC the importance of enacting the final rules in a timely manner?

Ms. SCHAPIRO. Absolutely, Mr. Chairman. We have the last piece of proposing rules for us, the financial responsibility rules for swap dealers and major swap market participants. I hope that we will issue that in the next couple of months.

There are also the two other key pieces from the SEC's perspective. One is, as I spoke about in my testimony, the implementation plan that will lay out in a policy statement our views on how the rules should be sequenced and implemented, what the compliance timelines would look like, and we will see comment on that. And, finally, a cross-border release that will talk about the application of each of our rules potentially to cross-border activity or cross-bor-

der operating entities, and we want to propose that cross-border release before we adopt final rules beyond the definitional rules.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

A lot of people have been basically saying, Chairman Gensler, that the CFTC and the SEC, Chairman Schapiro, were in the dark, that you did not know what was really going on at JPMorgan. We do not know that yet. But when did you first learn about these trades, Chairman Gensler?

Mr. GENSLER. I would say that the trades that came to, I think, many of our attention, personal attention, with press reports——

Senator SHELBY. Press reports.

Mr. GENSLER. But our staff was aware of trades that are in the clearinghouses because they monitor the clearinghouses daily in an aggregate basis for the clearinghouse risk and that the clearinghouse is fully collecting margin to protect the risk of the clearinghouses.

Again, we do not regulate JPMorgan Chase as a swap dealer yet, but we do regulate the clearinghouses, and then have anti-fraud and anti-manipulation authority.

Senator SHELBY. Did the CFTC really know what was going on there on such a large position that JPMorgan had taken here?

Mr. GENSLER. Well, again, our——

Senator SHELBY. Were you in the dark, or did you know what was going on? You said you learned about——

Mr. GENSLER. I would say that it is in transition to speak about this. Our oversight of the clearinghouses gives us a lot of window into the clearinghouse, which I think has 27 members in it, and the risks that are in that clearinghouse and the margin that is collected there. That is not the full JPMorgan picture, of course, because they have a lot of swaps that are not cleared. That would have been our principal regulatory role—in terms of the bank, we do not have any specific oversight there.

Senator SHELBY. So you really did not know what was going on or the problem with the trade until you read the press reports like all of us?

Mr. GENSLER. Well, that is what I have said, yes.

Senator SHELBY. Yes, sir. Chairman Schapiro, I will pose the same question to you.

Ms. SCHAPIRO. Certainly.

Senator SHELBY. Where was the SEC here? Did they know what was going on? And if not, why not?

Ms. SCHAPIRO. The SEC became aware of the activity, again, also through press reports back in April when the London Whale trading was first reported on. Just to remind everyone, this activity did not take place in a broker-dealer, and we do not have oversight responsibility over the broad-based CDS index products that were the subject of much of the trading, although I think there is still much to learn here about the full——

Senator SHELBY. And what was your responsibility, as you see it, as Chairman of the SEC, looking at what happened or trying to find out what happened at JPMorgan Chase? What is your responsibility?

Ms. SCHAPIRO. Well, clearly, our focus right now is on whether the company's public disclosure and financial reporting is accurate in light of what the press has teed up as what did they know and when did they know it.

Senator SHELBY. Absolutely.

Ms. SCHAPIRO. And so there were——

Senator SHELBY. And if they knew something, say, a month earlier that was going wrong, should they have disclosed that to the SEC, the CFTC? And is that what you are trying to find out now, or do you already know?

Ms. SCHAPIRO. That is what we are investigating right now. Were their earnings release statements and their Q1 financial reports accurate and truthful?

Senator SHELBY. But you are in the investigation of that now?

Ms. SCHAPIRO. Yes, sir.

Senator SHELBY. What did they know inside, when did they know it, and what should they have divulged; is that correct?

Ms. SCHAPIRO. Exactly.

Senator SHELBY. Is that correct, Chairman?

Mr. GENSLER. Yes, and as Congress gave the CFTC similar authority to the SEC—we did not formally have as strong an antifraud and anti-manipulation authority, which included also deceptive practices. That is part of this new authority that we have. We currently have oversight of the clearinghouses. I do not want to go into the particulars of this ongoing investigation that because it is really just best not to compromise the investigation itself. But it is in that realm of——

Senator SHELBY. As Chairman of the CFTC, though, in a derivative position like this, are you basically telling us that you did not know there was a problem there until you read the press reports? Is that basically correct?

Mr. GENSLER. I think that is accurate. We are also standing up a regime. We do not have any regulatory oversight of JPMorgan Chase National Association, the bank. We will, I think, at some point when they register as a swap dealer later this year, but they are not currently registered as a swap dealer. We have some oversight of their futures commission merchant, but that does not——

Senator SHELBY. Are you saying this is a no-man's land, there is nothing—there are things that have not crystallized in a regulatory fashion yet over such a big bank?

Mr. GENSLER. The bank is overseen by bank regulators, but under Dodd-Frank the market regulators, as market regulators, we will stand up and oversee swap dealing activity in a bank or an affiliate of a bank or securities-based swap dealing activity. But you are right, currently the American public is not protected in that way.

Senator SHELBY. Chairman Gensler, were any of the trades conducted through JPMorgan's futures commission merchant?

Mr. GENSLER. Not that I am aware of. Maybe upon further review we will find, but today our knowledge is no.

Senator SHELBY. OK. Thank you, Mr. Chairman.

Senator MERKLEY. [Presiding.] Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

At the last hearing the Committee had on MF Global, I asked the MF Global trustees—Mr. Freeh and Mr. Giddens who at the company was responsible for the wrongdoing there, and they informed me that their investigation was just beginning to determine that. I want to ask you both the same question. Can you shed any light at this point?

Ms. SCHAPIRO. Not at this point, no, sir.

Senator MENENDEZ. So you do not know at this point who is responsible for what took place at MF Global.

Ms. SCHAPIRO. No. I think the agencies collectively, including the criminal authorities, are working very hard to untangle exactly what happened at that firm.

Senator MENENDEZ. With reference to what happened at JPMorgan where the huge losses there take place, have you determine who was responsible at this point for that?

Ms. SCHAPIRO. No. As I said, our focus is very much—because we did not regulate the London branch of JPMorgan Bank, that is an OCC-regulated entity. The Fed is the holding company regulator. Our focus is on the quality of their risk disclosure and their specific disclosures as a public company. When they talked about their potential—all the risks that they faced as a business, when they talk about potential losses under their VaR model, we are very focused on the accuracy and the timeliness of that disclosure.

Senator MENENDEZ. In your—yes.

Mr. GENSLER. I would just say that we are aware that it is primarily in the bank, that much of this emanated from the London branch of the bank. And as news reports have suggested, credit derivative products are at the center of it.

Senator MENENDEZ. In reference to these investigations, are they criminal or civil?

Ms. SCHAPIRO. The SEC's authority is simply civil, not criminal.

Senator MENENDEZ. Are you working with entities that are conducting criminal investigations?

Ms. SCHAPIRO. I believe the FBI has announced publicly that they have opened a criminal investigation, and we will all work closely together even though we have different aspects——

Senator MENENDEZ. Into which of the two that I am referring to?

Ms. SCHAPIRO. I am sorry?

Senator MENENDEZ. MF Global?

Ms. SCHAPIRO. I think actually with respect to both.

Senator MENENDEZ. With respect to both, OK. So, in essence, it is the agencies that are conducting civil reviews, I assume, and to the extent that there are criminal reviews that are being conducted, they are being conducted by law enforcement entities. Is that correct?

Ms. SCHAPIRO. That is right.

Senator MENENDEZ. So it is not the Senate Banking Committee that is conducting those.

Ms. SCHAPIRO. I would not deign to tell the Senate Banking Committee what to do or not to do.

Senator MENENDEZ. But at this point, as far as I know, we are not. So let me ask you this: Do you interpret—do you hope to interpret the Volcker Rule in a way that what took place at JPMorgan

would not have been possible to have taken place, or would not have taken place without real consequences?

Ms. SCHAPIRO. I think we have obviously been thinking a lot about this, and the Volcker Rule is foremost in everyone's minds because of where we are in the process of reviewing comment letters, but also because of this activity. And it strikes me that the statute is pretty clear that in order to rely on the risk-mitigating hedging exemption to the Volcker Rule, there has to be some pretty strong criteria that needs to be met. Whether or not the JPMorgan trades out of their CIO meets those standards or not, I do not think we have a view yet. But they have to be correlated to the risk. They cannot give rise to significant new exposures. They have to be subject to continuous monitoring and management. They have to mitigate one or more specific risks on either individual positions or aggregated positions.

The compensation of the persons doing the trading cannot contribute to their taking outsize risk or unnecessary risk. And they have to, importantly, I think, document the risk-mitigating purpose of the trades when the hedge is being done at a desk that is different than the position that is being hedged was done at.

So I think there is strong language there, and what we need to do is take what happened at JPMorgan and view it through the lens of those criteria and see how that helps to inform the rulemaking going forward.

Senator MENENDEZ. Well, I hope, as one of those who supported the Wall Street reform legislation, that the agencies are going to look at this broadly because if JPMorgan lost $2 billion, or some report it as just slightly more, through these trades, what is to stop them from losing $10 billion the next time or, even worse, to stop another less capitalized bank from taking losses so large that it could bring it down? I mean, that is the whole effort that we tried to move here in the Senate, which is to have the type of reform that does not create the systemic risk that then places everybody in America responsible for the decisions of large entities such as this. And I hope that that is how the regulators at the end of the day understand that that was the mission that all of us who supported Wall Street reform wanted to see.

Thank you, Mr. Chairman.

Senator MERKLEY. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank both of you for your testimony.

When an event like one that has just occurred happens in the middle of a rulemaking process, that affects things, does it not? Meaning that you have an example, a real-live example, and, you know, we have had this issue, we realize it is a blip on the radar as far as their earnings. But it does affect the way rules end up being promulgated. Would you both agree?

Mr. GENSLER. I think it gives us real live experience, like AIG and Lehman Brothers and Citigroup did in a more disastrous way. This is not that, but it——

Senator CORKER. So I think, you know, as the American people are watching, they wonder why in the world we are having these hearings, and I think the point is that there is a lot happening at

the regulator level, and an event like this ends up affecting things, and it affects the rules that end up being created.

I guess I have this fear, I think much of what we did was a punt to you guys. I mean, the fact that—and you did not do that. We did that. But the fact that it has taken you 2 years to define what a swap is is pretty incredible, and it is because we never defined it ourselves or did the work to understand what a swap is. But the thing I guess I fear is in a rush to make it look like the Dodd-Frank legislation addressed these kind of issues, what you may do—I mean, we never debated what these institutions should be. We just sort of layered a lot on top. We have these highly complex organizations where even the CEO itself realizes that he did not know what was happening in this London operation. And I fear that you are under pressure, that a lot of calls are being made, that the Administration is concerned that the American people are going to wake up and look at the last 3 years as a bad dream, you know, that maybe the health care bill become unconstitutional, this big Dodd-Frank bill really does not address real-time issues, and that what you are going to do is end up causing the Volcker Rule to be something that it was never intended to be. And I just would like for you to respond to that, and in the process possibly making these highly complex organizations even more risky than they already are. I would just like a couple of comments in that regard.

Mr. GENSLER. I think our job that you delegated or asked us to do is to be——

Senator CORKER. "Punted" was the word I used.

Mr. GENSLER. I was trying to be more respectful to Congress.

Senator CORKER. You do not need to be.

[Laughter.]

Mr. GENSLER. And I appreciate that. I think it was to ensure that the American public gets the benefit of transparency and lower risk because firms will fail in the future, as they have in the past, and the critical thing is they have a freedom to fail, and the American public does not stand behind them. And it is like the one industry that we do this around the globe, and that is why I am so committed personally to getting this reform done.

I think this circumstance is just a reminder in one area—I look at it more about cross-border application than the Volcker area, if I can say respectfully, because whether it was Lehman Brothers, AIG, Long-Term Capital—Long-Term Capital Management, you might recall, was this hedge fund in Connecticut, but it was set up in the Caymans. It is just a reminder to make sure that we get that part right. The London risk can come back and hurt the good folks of your State.

Senator CORKER. Is there a pressure, though, to define what has occurred here in such a way that you may end up in the short term making a piece of legislation look good, but in the process cause a highly complex institution like this to be in a position where they are not appropriately hedging the activity so that you actually make it more risky? I mean, is that the kind of thing that you all do talk about from time to time?

Mr. GENSLER. Well, we are most definitely public actors, as you are as a member of this great body, the Senate, and we are influenced by—we have had 30,000 comment letters, 1,600 meetings

with folks from the markets. So this will be part of the topic of the dialogue, absolutely, but I think we have to, just as we always do to get it balanced and get it right, not, if your concern is, tip too far one way or the other. But I think it is a good reminder that risks in London can come back here, and we cannot have the U.S. taxpayers stand behind them.

Senator CORKER. So my time is going to run out, and I know by previous history I will be cutoff immediately. I do want to just ask that when you are making the rules that you are making, that we really do it here to the process of cost/benefit analysis. I am now moving to other types of regulations. I know that you know courts now are challenging some of the rules and regulations because regulators are not doing that.

And, second, to ensure that we do not create another systemic risk by shifting off to these clearinghouses systemic risk that otherwise was held in other places.

So, anyway, I thank you for what you do, and I look forward especially to the next hearing we have with the banking regulators that actually are supposed to oversee these activities.

Thank you.

Senator MERKLEY. Thank you, Senator Corker, and thank you all for your testimony.

I wanted to start with returning to the basic premise of the Volcker Rule, which is to create a firewall between traditional banking, that is, deposit-taking/loan-making institutions, and hedge fund-style investing.

In the effort to create that firewall, one of the issues was when banks were holding funds in between making loans, how would they be able to utilize those funds so that they had liquidity for making loans, but it was relatively safe, so it is clearly not in the world of proprietary trading or hedge fund investing, if you will? So the basic statute provided for a notion of investing in Government bonds as kind of the safe place to put your money, but allowed the regulators additional flexibility.

The draft regulations have the liquidity management proposal, and it is not really clear in the end what would be allowed here. But if we look at JPMorgan, they have $381 billion in funds that were awaiting, if you will, lending out, so in between loans. Unlike other institutions that largely put it into Government bonds, they took half of that and they put it into corporate bonds. That started this sequence of events that led to this $2 to $3 billion or greater loss, and that they then said, well, we have these corporate bonds, we better protect against them dropping in value, and they bought some insurance. And then they said, well, we have got to pay for that insurance, so we will sell another form of insurance to create the revenues to pay for that. And pretty soon they were in the position of doing what AIG did, which was to sell lots of insurance very cheaply, and then when the bets went bad, they had to pay off.

So it begins with this liquidity management issue, and that really has not been focused on much here. But what is the appropriate place to put your funds in between making loans so that you are clearly in the deposit-taking/loan-making business and not in the hedge fund business?

Ms. SCHAPIRO. Senator, I think that is a great question, and the rationale behind the liquidity management exclusion that was included in the rules was to make sure that banking entities would have sufficient readily marketable assets to meet their short-term liquidity needs, and I think we can all agree that is really critical to the safe and sound operation of a banking entity. And there are requirements around that that there has to be a documented liquidity management plan, and there are criteria that are set out in the rule. But I think the question you raise really requires us to go back and look at that and see if we carried that to its logical extreme, could we have anticipated to JPMorgan and maybe we need to tighten this up and just look at it much more closely and much more carefully.

That is why I think really in response to Senator Corker's question, this is very instructive. It would be wrong for us not to take this example that is a real-life, real-world example of what can happen, whether it is the application of the cross-border provisions or it is the Volcker Rule itself, to use this example and to see what the impact would be of all the things that we have proposed to do.

Senator MERKLEY. So I would say if you take the situation that funds that are awaiting making new loans, if you will, can be invested in a huge variety of things, and essentially it is a gateway to be involved in proprietary trading, and it has two impacts. One is it diverts funds that were intended to be lent out the door, reducing liquidity or credit for businesses and families; and, second, it introduces a lot of risk and complexity.

Chairman Gensler?

Mr. GENSLER. Well, as a derivatives and swaps regulator, we are mostly going to be focused on the implementation of the Volcker Rule with regard to swap dealers and futures commission merchants. I do not have as many views as Chairman Schapiro on the liquidity management piece, but if I could pick up on a second, I think implied in there, was we received a letter from JPMorgan all of us received on our side of the regulators—in February specifically saying that they thought we had to loosen up or widen out the hedging exemption. We are entrusted by Congress to figure out how to prohibit proprietary trading so taxpayers do not stand behind these institutions, but permit market making, which is important to markets, and permit hedging, which helps lower risk of these institutions. So it is that challenge—it is not an easy challenge, by the way. But I think you were very clear. It has got to be tied specifically to individual or aggregate positions, and I think Congress was pretty clear on that, and it is instructive to me that it was actually February 13th that JPMorgan sent in like a 65-page letter, and within that they said you have to loosen up this portfolio hedging. And so I think this has to be looked at in the context of their February letter as well.

Senator MERKLEY. Great. I am out of time, so we are going to return to Senator Johanns. Thank you.

Senator JOHANNS. Thank you, Mr. Chairman.

Thank you both for being here. Madam Chair, let me follow up on a statement you have made a couple of times during the hearing that I just want to understand better. You said that SEC did not regulate the London branch, that that actually was something over

on the OCC side. And I am trying to maybe take the next step here with my question. Could this risk management that was being done by JPMorgan have been done in such a way that it would be under your jurisdiction? Or are you just saying this does not fall within the purview of the powers given to me?

Ms. SCHAPIRO. If the trades were done in an SEC-regulated entity, broker-dealer or ultimately when the rules are finalized a security-based swap dealer, then it would clearly be under the jurisdiction of the SEC.

Senator JOHANNS. OK. Which, of course, raises another question. If I were running JPMorgan, couldn't I just set this up in a way to avoid you?

Ms. SCHAPIRO. Well, that is an important issue that we are all wrestling with in the context of the cross-border release and how will we apply our rules to activities that might not take place in the U.S. entity but might face a U.S. customer or might take place in an affiliate of a U.S. entity but overseas or in a branch of a U.S. entity overseas. And those are the issues that we will lay out in our cross-border release.

I think generally a foreign entity with a foreign customer, we can feel reasonably comfortable that our Title VII rules would not apply. But the foreign affiliate of a U.S. entity—rather, a foreign entity that is registered with us doing business with a foreign customer would likely be subject to our rules. A U.S. entity, including a branch of a U.S. entity, operating in a different country or doing business with any U.S. person would have Title VII rules applying. So we want to lay this out in detail for commenters.

Senator JOHANNS. One of the concerns about Dodd-Frank, and maybe even more specifically this area of Dodd-Frank, as you know, and it has been one of my concerns, is the more you crank it down, the more the regulations become more and more onerous, the greater the temptation is for smart people to hire smart lawyers and accountants and at the end of the day avoid you.

Ms. SCHAPIRO. That is right, and that is why the international efforts we are engaged in really are critical here, and they are painstakingly time-consuming as we sit on a bilateral basis and a multilateral basis with regulators in the other major markets and go through issues like pre-trade transparency, post-trade transparency, margin, the clearing mandate, the exchange trading or SEF mandate, and work through each and every one of these issues to try to get the regulatory regimes as comparable as possible so that there is not an opportunity for people to engage in regulatory arbitrage and just do their business in the least regulated market.

But if it faces U.S. customers and has the potential to impact the U.S. financial system, we have to very seriously consider making that part of our mandate.

Senator JOHANNS. Mr. Chairman, I want your comments on this, but before you comment, when you say—and I have no doubt you are working hard in the international arena and you want everybody to be as harmonized as they can be. But I have worked in that international arena in a position much like yours, and, you know, we would work days, weeks, months, years with the WTO process, for example, with 150 countries trying to get people on the

same page for sanitary/phytosanitary issues in trade. And at the end of the day, they all had their own agenda, and they all had their own interest. And some saw an economic benefit in doing something very different than what we were proposing they do.

And before I take all the time, go ahead, Mr. Chairman, because I could go on and on. I think this is a very serious problem.

Mr. GENSLER. I think, Senator, you are right on both points, that we will ultimately have differences. We are working well together, but there are different cultures, different political systems, different agendas. There will be some differences. And, two, I think you are correct that modern finance, large complex financial institutions will rationally look to see whether they can find the lowest tax regime and accounting regime that favors them or regulatory regime that they can put customer money at risk or have less capital and so forth.

So knowing those two things—that there will be differences and that rationally these large firms will do all this—I did it once when I was a co-finance officer of a large firm. I mean, you know, we set up four to six legal entities in every jurisdiction, and Long-Term Capital Management's was in the Cayman Islands, and Citibank's SIVs were originated in London but set up in the Caymans. And AIG financial products that we think were in Connecticut, they needed a bank license, so they went to France and they got a bank license, and they put a branch in London. Joseph Cafano, the gentleman who ran it, was running it out of London. All that risk came back here.

So we have to be very careful, as Chairman Schapiro said, to say, yes, there are costs on financial institutions, yes, there will be differences overseas, but the bigger cost is if we let the American taxpayer be at risk. So we are trying to cast this appropriately where there is direct and significant effect on U.S. commerce or activities.

Wall Street rationally is advocating something different. If I was on the other side of the table representing them, I would advocate something different than I am in this job right now. And so it is an interesting challenge, and we are not going to be as good as we hope to be. They will get something by us. In probably 3 to 6 years or 10 years somebody is going to say you missed something, they figured out something in the Mauritius islands or something.

Senator JOHANNS. Mr. Chairman, thank you.

Senator MERKLEY. Senator Reed.

Senator REED. Well, thank you very much. Chairman Schapiro, you have already indicated that you do not have direct jurisdiction over the activities of the JPMorgan entity, but in this joint rulemaking, this collaborative rulemaking, you are trying to define hedges in a way that covers the legitimate operations of financial institutions minimizing their risk, without allowing speculation.

There is this tension, it seems, the tension between risk management and profit making, and I know you have suggested sort of the criteria. Do you have anything else to add in terms of this dilemma of defining a hedge so that it is properly protecting clients and protecting investments of the bank but not opening it up to, you know, speculation?

Ms. SCHAPIRO. Well, I think that is the hard challenge that Congress has given us, and I would say it is also true with the market-

making exemption as well. And we believe deeply that businesses have to be able to engage in both activities, market making to ensure our markets are operating as efficiently as possible and hedging to reduce businesses' risk. And I think the criteria that are laid out are actually pretty good in terms of helping us keep the focus on hedging as truly hedging, you know, mitigating one or more specific risks of either individual positions or aggregated positions, the hedge itself not giving rise to significant exposures, at least at the inception, but also monitoring and adjusting hedges if, as we have seen in some of the newspaper articles about the JPMorgan transactions, they morph into something else over time, that there not be compensation programs, and as you know, we have been working hard in the disclosure area with respect to compensation, that really incentivize this outside risk taking in a way that threatens the franchise by encouraging people to take bigger risks than they should.

So I think the criteria are there. I think it is really incumbent upon the regulators to figure out how to write a rule that allows legitimate hedging to go forward as it needs to, but it must be really, genuinely risk-mitigating hedging, and not anything people want to do called hedging.

Senator REED. There is another variation on this that you have to deal with, and that is, we in Dodd-Frank have end-user exemptions. For a nonfinancial company, you could be doing hedging as an end user, but you could also be very aggressive in your hedging. We saw the example of Enron, which was not, you know, a financial company, but it collapsed because of very aggressive use of derivatives.

Is there anything that you are contemplating in your rules or anything you are going to do to anticipate this type of problem, Chairman Gensler?

Mr. GENSLER. Well, I think actually Congress anticipated it because they included another category called major swap participant. And I think Congress said that if you are nonfinancial, you get to choose whether you are involved in this clearing and trading, and we are suggesting through our margin rule that you get to choose on that, too. But if you are so big that you are a major swap participant and you could be systemic, then you would be brought into this.

Could I answer your first question just a little bit?

Senator REED. Yes, please.

Mr. GENSLER. I think that Chairman Schapiro said it very well. One thing I would add is that this concept of portfolio hedging can mean different things to different people. I think what Congress said, it has to be tied to specific risk of individual or aggregate positions, and this experience reminds us maybe we have to go back and make sure. It really is tied to specific aggregate positions. It is not sort of like, well, we think revenues will go up or we like the European debt markets these days. And one thing from my experience is that these things sometimes morph or mutate into something else, particularly when they are set up as a separate business unit and they have a separate profit and loss statement and separate compensation, because hedges, to really be hedges, generally lose money just about as many days as they make money

because they are hedging something, the position is going up, the position makes money, the hedge loses money; and if the position goes down, vice versa. When you set it up as a really separate unit somewhere else, maybe in a different country, different leadership, you start to—it is prone to morph.

Senator REED. Yes, I guess one of the—it is just an initial reaction, and maybe it is untooted, is that when your entity that is designed to be sort of the risk manager and chastise everybody in the institution for being too aggressive or not responsive to risk is really one of your major profit centers, and I think that might be a sign that the role is emerging in a sort of unpredictable and maybe unproductive way.

Just a final point I want to make, not in response to a question, is that you pointed out, Chairman Gensler, the international interconnections here, which suggests very strongly that our regulations have to be not only strong and internationally applicable, but we have to have people on the ground looking at these institutions. If an American institution is going to locate their activities overseas, the comparable regulator, in this case OCC, should not only have been there, but been there in force with adequate personnel to look very closely at what was happening and be the first line of defense, if you will.

Mr. GENSLER. Well, I cannot speak to them, but I think the system we have at the CFTC, unfortunately—or fortunately—does not contemplate that. We really have been kept reasonably small. We are just 10 percent larger than we were in the 1990s. And we rely foremost on the law and people complying with the law, on the rules, and then the self-regulatory organizations. We do examine the self-regulatory organizations, but we do not have people onsite at any futures commission merchant. We do not have people onsite at the clearinghouses. That is just the reality of our funding and the decisions that have been made over decades in a bipartisan way.

Senator REED. But just a point, I mean, there have been questions consistently here today. When did you know? When were you aware of it? Could you have anticipated it? Recognizing it is OCC's responsibility, if they do not have people on the ground sitting day to day at the desk, you will not know until some enterprising reporter breaks the news, and by then a lot of damage could be done.

Mr. GENSLER. Agreed.

Ms. SCHAPIRO. The other tremendous benefit we do get, though, will be when we have full reporting of these transactions and there is transparency to regulators I think will make a big difference.

Senator REED. Thank you, Mr. Chairman.

Senator MERKLEY. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and thank you both for being here. I would like to follow up on the discussion that Chairman Gensler has been touching on but I am a little bit confused about, and that is, your views on the permissibility of hedging in the aggregate. I think you just used the expression just a moment ago about portfolio hedging that is tied to specific positions. So I am wondering if you could clarify that, because if you tie hedges to individual specific positions on a one-off basis, that

is obviously the opposite of hedging in an aggregate portfolio that has some kind of cumulative net risk.

So my question is: Is it your view that it is and will continue to be permissible as well as cost-effective to manage interest rate and currency and credit risk in the aggregate in these portfolios rather than limiting it to a one-off individual basis?

Mr. GENSLER. I think Congress actually addressed themselves to this and said that it had to be tied to the specific risk of either individual or aggregate positions, but tied to the specific risk of some aggregate positions, to answer——

Senator TOOMEY. OK. So——

Mr. GENSLER. But it has got to be tied to some——

Senator TOOMEY. So, for instance, it could be the aggregate interest rate risk of a bond portfolio——

Mr. GENSLER. That may have 170 bonds in it, and then they——

Senator TOOMEY. All across the maturity spectrum, so you could measure that and quantify that and then hedge that. And then would the rule prescribe the kinds of instruments that would be permissible to use to hedge that kind of portfolio?

Mr. GENSLER. As written now, it speaks to—and this may change in a final rule, but as written now, it talks to instruments that are reasonably correlated with the risk. So it is all in that word "reasonably."

Senator TOOMEY. And who decides what is reasonably correlated to the risk? Ultimately the regulator do.

Mr. GENSLER. Well, I think a first order, the institution does, the firm does, but then there is a compliance program, and the regulators would——

Senator TOOMEY. But the whole point of the rule is ultimately for you to set bans and say this is permitted and this is not. And that is the purpose of the rule.

Mr. GENSLER. It is, though as written, I would consider it more a principles-based and compliance regime that the firm has to have policies and procedures to ensure that their hedges are reasonably correlated to the specific risk.

Senator TOOMEY. But, again, I think the ultimate question in hedging is a question of who gets to decide, I think. There is an inherent risk in hedging. That is why it is called a "hedge," right? It is not a complete offset. And so there is always some residual risk, and there is always a subjective judgment call since in large, sophisticated, complex, liquid markets like ours, there are a lot of choices available to someone who wants to hedge any given portfolio. And my concern, Mr. Chairman—and it goes to the heart of what Dodd-Frank is all about, and these folks are doing their job of trying to implement it, but I think they are given an impossible task, and the task is to micromanage the activities of these institutions. That is what Dodd-Frank attempts to do. It says we are going to limit systemic risk by controlling everything you can do in great minute detail.

Let me give an example. Chairman Schapiro alluded earlier to the challenges of establishing the market-making exemption. My understanding is among the many specific rules that we are going to impose on financial institutions, we are going to establish metrics that will quantify, for instance, how much income can be

earned from the day one bid-offer spread versus what can be earned from subsequent market moves. We are going to have rules that will prescribe how much business a market maker must do with end users versus that which would be done with the inter-dealer community. We are going to have to decide and have rules that will dig down into whether we are going to quantify these things at the level of the individual trader—or will we aggregate several traders? Or will we aggregate the entire trading floor? How will we do this?

We are going to have to have rules that will establish which kinds of asset classes are permitted to hedge which kinds of risks. So if you have got a corporate bond portfolio, that has credit risk. Can you short the S&P 500 against that as a proxy for credit risk? Or can you use credit default swaps?

My point is this has a huge cost, not just the direct staggering cost of compliance, but it also has a cost of less liquidity because traders have fewer options. It is going to lead to less innovation because people are going to be prescribed very narrowly in what they can do. And it is going to have who knows what kind of unintended consequences, as Senator Johanns observed, when people decide, you know what, it is better to just avoid this incredible micromanagement and go somewhere else, which is why, I think, Mr. Chairman, we have gone down the wrong road here. The better solution is require more capital so that we can let people do what they want to do, let the people in the marketplace make the decisions they will make, and then let them live with the consequences without having the taxpayer at risk because we have required a sufficient buffer that a firm could lose 1 percent of their capital in a recent example and not have everybody sweating bullets about it.

Frankly, firms ought to be able to make decisions and then live with the consequences, and taxpayers should not be at risk. I do not think you achieve that by trying to control every aspect of their business, which is what these folks, unfortunately, have to do. I think the alternative of a tougher capital regime achieves the goal of reducing systemic risk without putting us in the impossible position of trying to run these institutions.

Senator MERKLEY. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman. And, Chairman Gensler and Chairman Schapiro, thanks for your comments today and your commitments.

Chairman Schapiro, in Senator Reed's discussion, you mentioned data collection. When will the SEC start collecting that data? And where does the implementation stand?

Ms. SCHAPIRO. The security-based swap reporting data collection will begin when the rules are finalized, which they are not yet, for Regulation SBSR. It is hard for me to predict with a five-member Commission exactly when we will have final adopting rules, hopefully sometime later this year. We have one set of rules left to propose, and then we have done one final. We will do another final in the next month or so, hopefully, and then a steady stream after that.

It is important, obviously—I am a big believer in transparency in the marketplace, and we have seen it work extremely well in other markets. We think it is critical for the public to have access

to this information and very critical for regulators to have access to this information. It is a discipline that ultimately translates to, I think, management as well to know that the regulators and the public can see the information.

So when we do have the rules in place, we will have quit granular information right down to the trader and the trading desk from which a particular transaction emanated.

Mr. GENSLER. And I would say, and maybe to Senator Toomey's comments earlier, I think transparency is so critical, too, so I am hoping that I could maybe convince you that, in addition to capital, transparency, because as Senator Hagan said, in the credit default swap indices area and in interest rates and so forth, it will be later this summer, probably as soon as—possibly as soon as August. And then in the commodity—oil and gas and the others—3 months after that, because we have already completed the rules both for the public to see the trades, which I think is very big, and then for the regulators as well.

Senator HAGAN. Chairman Gensler, speaking about transparency, you and I have talked at length about that, especially in the swaps market, and I think we all do agree that transparency obviously is critical to reducing the risk and creating the efficient markets.

The Markit's CDX North American Investment Grade you mentioned in your testimony. It certainly has received attention recently for the role it played in the losses at JPMorgan. And this index of credit default swaps contracts is a relatively transparent product that is tradable, that is standardized, and it is priced daily.

I would like to hear your thoughts on the transparency of a product such as the CDX index and how that can reduce risk in the financial system. And then how could we see such large losses in this tradable product? And what lessons do you think our financial institutions will take from this incident?

Mr. GENSLER. Well, I think you are correct that it is a rather standardized product. Right now the dealers are into a clearinghouse, but as we complete the rules, the nondealer, the hedge fund positions, will also come into the clearinghouse. Regulators will get more transparency seeing all of the trades not only in the clearinghouse but in the data repository.

For the public, right now there is not mandatory post-trade transparency, and I think as that comes into being in the next several months, there will be a benefit in that the public would see the pricing.

Now, we mask the sizes. If somebody did a very large size trade, it just gets a plus at the end. I apologize. I cannot remember where it gets a plus, whether it is at $100 million size or $200 million in credit default swaps. But I think the public will greatly benefit from such transparency in addition to the regulators.

Senator HAGAN. Thanks.

Chairman Schapiro, I wanted to ask about the value-at-risk, an industry standard reporting metric that I think most of the financial institutions include in their 10–K filings. Can you discuss the value-at-risk and how it is used by the financial institutions and what are the rules regarding its disclosure?

Ms. SCHAPIRO. Sure. The VaR estimates, or value-at-risk estimates, give you at a particular confidence level, 95 percent, 99 percent, the potential decline in the value of a position or a portfolio under normal market conditions. And I would say that raises one of the weaknesses of VaR, is that it does not measure for you the maximum possible losses in a portfolio that could occur, could be incurred, particularly during very stressed market conditions. So it has its limitations.

Nonetheless, public companies are required to discuss their risk, and they are given an option really of three ways to go forward in their Item 305 Regulation S–K disclosure. When they have to give quantitative information about market risk, they can use a tabular presentation of information; they can do a sensitivity analysis; or they can do a VaR disclosure. And most financial institutions, in fact, choose to do that.

They also have to disclose at the same time, though, any material limitations on the model, what it is not telling about risk exposures, and when there are changes to the VaR model as newspapers have reported was done at JPMorgan, they changed their VaR model those changes have to be disclosed, too. The changes to the model characteristics also have to be publicly disclosed.

Senator HAGAN. And have you followed that at some of these other losses that have taken place in the recent past, how it impacted from the SEC evaluations?

Ms. SCHAPIRO. Our staff would look at—well, particularly in the capital context, where VaR is also used to allow firms—certain firms, a very small number of firms, in fact—to use VaR to compute the market risk deduction from net capital. If they have large losses, we actually make them back-test and provide us with full information about why their estimates of losses were so far of.

Senator HAGAN. Thank you.

Senator MERKLEY. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

My first question relates a little bit to funding. We have heard a lot of people being critical, why didn't you know more about this. And, obviously, that takes staff, and you have been given huge amounts of responsibilities but without, in my judgment, the concomitant resources to fulfill all those responsibilities. That is one of the reasons things are taking longer than they should. That is one of the reasons you are not everywhere.

I think one of my greatest regrets in the Dodd-Frank bill is we had a proposal—it did not affect the CFTC, but it affected the SEC—that would have allowed all of the—a little levy on transactions that is supposed to fund the SEC to actually fund the SEC, and, unfortunately, we had an internecine fight here, and the Appropriations Committee insisted on not doing that. They have increased your funding, but not to the extent that it would have been under Dodd-Frank, the proposal I had in Dodd-Frank.

So could you talk for a minute about the funding issue and how vital it is, especially in relationship to the oversight that you are being asked to do by everyone on both sides of the aisle?

Ms. SCHAPIRO. Sure, I would be happy to start. As you point out, we have been asked to take on very significant new responsibilities, not just over-the-counter derivatives but hedge funds that are now

registered and overseen by the SEC, municipal advisers, which will add many new registrants, specialized corporate disclosure, a whistleblower program, quite a lot of new responsibilities.

In fiscal year 2012, the current fiscal year, we asked for 116 new positions for Dodd-Frank implementation. We did get a very good budget for fiscal year 2012—again, not as good as had we been self-funded, but we were very grateful to get an increase at a time when many agencies did not.

So the hiring is going on right now for those new positions, and I will say we have fortunately been able to attract tremendous talent to the SEC and very different skill sets than we have traditionally had.

Senator SCHUMER. What about investment in technology, which is often more than a 1-year deal?

Ms. SCHAPIRO. Yes, it is, and we have made technology investment a significant focus of our additional resources and have been able to make dramatic improvements, I think, in the agency's core technology.

That said, we are still way outgunned by the firms that we regulate in terms of technology, but we are making, I would say, steady progress in that regard.

For fiscal year 2013, when many of these new rules will actually start to be in effect and we will have the clear responsibilities for oversight and monitoring of the security-based swaps market, we have asked for an additional 273 positions.

Senator SCHUMER. So that is a lot.

Ms. SCHAPIRO. It is a lot.

Senator SCHUMER. What are the vibes on the Appropriations Committee?

Ms. SCHAPIRO. They do not show their cards.

Senator SCHUMER. Well, we hope they do soon.

Chairman Gensler?

Mr. GENSLER. Thank you. I applaud your efforts in the Dodd-Frank Act to get Mary's agency self-funded.

Senator SCHUMER. You were in the conference committee trying to do the same thing, but we failed in both cases.

Mr. GENSLER. I think that this is a good investment for the American public. The CFTC is funded at about $205 million. But I liken it to football, if you are a football fan. Imagine if all of a sudden there was 8 times the number of teams but no more referees, and then instead of having seven refs on the field you had one on the field. What would happen? There would be mayhem on the field. There is sometimes mayhem in the financial markets anyway, but hopefully with seven refs, there is less of it. And the fans lose confidence, in this case market participants. And ultimately in these derivatives markets, you need the corporate end users to have confidence that when they enter the market, they can do it free of fraud and manipulation. They can enter the market with speculators on the other side. That is not a bad word. But that they feel that the market is a fair and accurate reflection of the pricing of risk. And so we are way underfunded at the CFTC.

Senator SCHUMER. OK. I agree with your comment in reference to Senator Toomey that even if you think capital requirements are the major protection here to provide the cushion, maybe because

you cannot regulate every single little trade, that transparency—that does not gainsay the need for transparency, so I would like to follow up on my good colleague from North Carolina's questions on that.

We know from media reports that the JPMorgan losses involved large positions in broad-based indexes comprised of credit default swaps on over 100 companies. As I understand it, the vast majority of trades in this index are recorded in DTCC's Trade Information Warehouse. So that would mean regulators have access to some information about overall activity in the markets, but may not have information about exactly who was buying and who was selling. Is that correct?

Mr. GENSLER. That is correct, though I think as our rules go into effect over the course of the next several months, we will have that information more specifically, and we already do have it in the clearinghouses. A significant portion of these transactions dealer to dealer are in the clearinghouse.

Senator SCHUMER. Right. And as I take it, the counterparty coding system is what you are talking about? Or will that add additional information?

Mr. GENSLER. Well, that will add additional information through—it is an international arrangement on legal——

Senator SCHUMER. Right. What is the prognosis of that coming into effect? When?

Mr. GENSLER. Well, on the index credit default swaps, we finalized rules last year which go into effect 2 months after we finish our joint product rule—another reason we need to finish the joint product rule—and the legal identifiers to which the Senator refers, we are actually, I think, going to announce in a week or 2 weeks that we put it out to a service. Four parties came in and it looks very close that we will pick somebody, and that will be up and running.

Senator SCHUMER. Just one more quick question, which is a consequence of this. Would it be possible to set up an early warning system that would warn us if, say, a single company accumulates unusually large positions in any single product? Is there any warning system that regulators could develop that could help identify risky positions?

Mr. GENSLER. I think on the first part, yes. The second, it is a little harder. Early warning, that is what we do now in the futures world, in corn and wheat, and even interest rate products.

Senator SCHUMER. Right.

Mr. GENSLER. We hope and plan to do that in the swaps products.

Senator SCHUMER. It is harder to do, I guess, because they are more complicated?

Mr. GENSLER. More complicated, but once we have the information and tie into it and have the funding, we meet every Friday in a closed-door surveillance meeting where we go over significant positions in the markets.

Senator SCHUMER. So you think your surveillance is going to get better?

Mr. GENSLER. It is going to get better, but underfunded, it is stretched and thin, and something is going to give. It could give in

the wheat market. It could give in the oil markets. But something will give.

Senator SCHUMER. Do you have any comment on that, Chairman Schapiro?

Ms. SCHAPIRO. No, I think the clearinghouses also obviously, to the extent these instruments are mandatorily cleared, will have clear insight into early warning levels, concentrations by particular firms, and be in a position to adjust the margin requirements to account for that.

Mr. GENSLER. I might just add, the clearinghouses, the two main clearinghouses, one is called ICE Clear Credit here in the United States and ICE Clear Europe over in Europe, have a concentration where, when positions get large, they actually add additional margin on top, and without getting into the details, you can imagine what happened here.

Senator SCHUMER. Yes, you can.

Thank you, Mr. Chairman.

Senator MERKLEY. So we are going to have additional 5-minute rounds. Senator Shelby.

Senator SHELBY. Thank you. I would like to go back to MF Global, if I could, Mr. Chairman. Chairman Gensler I am referring to. Chairman Gensler, this Banking Committee's due diligence has basically revealed to a lot of us that you played an active role in the oversight of MF Global during the week leading up to its failure. We would like to know how many conversations did you have with MF Global CEO Jon Corzine during MF Global's final week. And during these conversations, were there any discussions about possible shortfalls in customer accounts? This is central to what we are looking at.

Mr. GENSLER. I thank you for that question. I had no individual conversations with Jon Corzine. I did participate on that Sunday on a group call with Chairman Schapiro, our staff, her staff—I think New York Fed and the London regulators were on as well—with presentations coming over a conference call with 40, 60 people on it, which I believe once or twice Jon Corzine spoke up and gave some information.

If I could answer your further question, I think, about what was my role that weekend, would that be helpful? During that week——

Senator SHELBY. You were the Chairman—and you still are—on that day.

Mr. GENSLER. Yes, yes, yes.

Senator SHELBY. Of the CFTC. Go ahead. What was your role as Chairman?

Mr. GENSLER. My role as Chairman of the CFTC, as that week developed and the firm looked to be in a frail state, to ensure for the movement of customer money, over that weekend we were informed by other regulators—FINRA, actually, I think was the first one to inform us, and I compliment them for that—that there were negotiations going on to move the position. So we wanted to ensure that those customer monies and positions were moved. We were assured from the company and from the first-line regulators, Chicago Mercantile Exchange, that all the monies were there. It was only about 2:30 in the morning when I was woken on Monday, the 31st

of October, that I learned of the shortfall. But the Sunday was really about moving the customers, and the key focus—we did not care beans about Jon Corzine. We cared about the thousands of customers that needed those monies moved, and we were assured all the money was there and CME had been checking the books.

Senator SHELBY. How many people did you roughly have onsite at MF Global?

Mr. GENSLER. I am not aware of the number, whether it was—it was less than a handful, but I think starting Thursday, we sent some folks in on Thursday. Friday, the full Commission in our surveillance meeting got a briefing that Friday morning. And the briefing was that they were in what is called "segregation compliance." But then over the weekend, we kept asking questions for more details because, you know, we wanted to see the details. It was not fully forthcoming, but by Sunday, we were on these joint calls together, the SEC and others, and hearing, no, it is all there. And then we actually asked to talk to the buyer late Sunday night—Interactive Brokers it was at the time—to see that they were guaranteeing that they would ensure all the monies as well.

Senator SHELBY. So that was the steps you are relating that you took to protect the customers' assets after learning that customer assets were missing?

Mr. GENSLER. Well, no. All throughout the weekend, we were assured by the company and also the front-line regulators they were in compliance. The law is that 24 hours a day, every minute of every day, one is to be in compliance, and one must report if you are not.

Senator SHELBY. You are either in compliance or you are not, right?

Mr. GENSLER. Yes, it is just—it is really straightforward.

Senator SHELBY. And you are supposed to protect your customers' funds separately. Is that right?

Mr. GENSLER. Absolutely. It is at the critical heart of the——

Senator SHELBY. So when we talk about segregated accounts, that is what you are talking about?

Mr. GENSLER. That is what we are—and people here, I agree with you, sir, were hurt because that did not happen. I am not involved in the specific investigation, and I chose—even though the General Counsel and the Chief Ethics Officer said I could be, I said I thought that once it turned to an investigation that specifically was about Jon Corzine possibly, I thought that made sense to step aside.

Senator SHELBY. Let me ask you this question, Mr. Chairman. On what date and at what time did the CFTC staff first learn that there was a possible shortfall in the customer segregated accounts?

Mr. GENSLER. Well, I can only speak to what I remember, but what I remember was being woken up at 2:30 in the morning by——

Senator SHELBY. Was that on Sunday?

Mr. GENSLER. No. Monday.

Senator SHELBY. Monday morning.

Mr. GENSLER. Well, technically the 31st of October.

Senator SHELBY. OK. And after you learned there at 2:30 in the morning on Monday or Sunday night of the missing customer as-

sets, what specific steps did you take to ensure that customer funds were not improperly transferred over the weekend before the firm failed?

Mr. GENSLER. Well, this was already Monday. I put on my bathrobe and I went to a conference call and joined it with other regulators, and I think it was 4 to 6 hours later that it was put into a SIPC proceeding.

Senator SHELBY. On October 30, 2011, a CFTC employee gave to CME, Chicago Mercantile Exchange, employees a disk containing documents to support MF Global's October 26, 2011, segregated funds statement, which initially showed no shortfall. When did the CFTC, Mr. Chairman, receive this disk from MF Global?

Mr. GENSLER. I am not familiar with the disk, Senator.

Senator SHELBY. You are not familiar. OK. It is our understanding that the CFTC did receive the disk and that the CFTC began reviewing the documents of the disk, and we would like to know when, and I will ask you for the record. And what was the result of this review of these documents? And did it show any shortfall? I think we would like to know, and if you do not know, you can get this information——

Mr. GENSLER. So if the General Counsel could follow up and make sure that you get the information that you asked for.

Senator SHELBY. For the record.

Mr. GENSLER. For the record.

Senator SHELBY. OK.

Senator SHELBY. Chairman Gensler, in May, about a year ago, May 2011, FINRA determined that MF Global had a capital deficiency. MF Global CEO Jon Corzine personally appealed that decision to the SEC, chaired by Chairman Schapiro. The SEC upheld FINRA's determination, and MF Global publicly reported the deficiency in August of 2011.

When did the CFTC first learn that MF Global had a capital deficiency?

Mr. GENSLER. Again, if I——

Senator SHELBY. Did you learn it then? Or did you never learn it. Go ahead.

Mr. GENSLER. Again, if I could have the General Counsel follow up on the specifics, but as I recall, my own memory was over the course of that summer. But they could follow up as to specifics if there was a date that the staff learned it.

Senator SHELBY. Well, that goes to the heart—and I would be interested in the answer—of the SEC and the CFTC's coordination of the regulation. So if the SEC did something that they should have, upheld the FINRA determination, and if the CFTC did not know that, then there is a problem. But if you did know it and did not do anything about it, that is a problem.

Mr. GENSLER. My memory is that there was coordination, but as to the specific dates and times, that I do not recall.

Senator SHELBY. Thank you, Mr. Chairman.

Senator MERKLEY. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and I apologize for being out for so long. Maybe I will—I do not have a specific question on MF Global, but there are two quick questions I would like to ask and get on the record. One is, I mean, some of the items

that Senator Shelby was mentioning was this issue of coordination between your two agencies on approach to rule implementation. One of the things that I have been concerned for some time on is that in Dodd-Frank, very active in Title I and Title II, and we created the Financial Stability Oversight Council to try to have this forum for what I thought at least or hoped would be resolution of areas where there might be this rubbing. I was particularly interested in one area. I think Senator Shelby did not agree with me on this one, but on the OFR, which would be, in effect, the independent repository of data and information so that the FSOC could have the ability to adjudicate, if need be, between different interpretations or conflicts on agency promulgation or on rule promulgation.

We are very concerned that the Administration has been a little bit slow on getting the OFR nominee. They now have one together to get passed, but I would like you to weigh in on FSOC's ability to—maybe not so much with the MF Global circumstance but be that adjudicating body where issues rise up, and has it been effective or not. Either one—and I have got one follow-up as well.

Ms. SCHAPIRO. I am happy to start. I actually think FSOC has turned out to be a very good forum for the agencies to share concerns and ideas and differences as they arise and have a discussion and hear the views of other people from their unique perspectives regulating different types of institutions but all connected within the financial markets. So I think we are working on our next annual report that will try to lay out the systemic risk issues that we see facing the economy. Every agency contributes to that, and those particular issues become, you know, very lively discussions for how to approach particular problems.

I think OFR hopefully is starting to get going in a more meaningful way, and I think it can be an important adjunct to the work of the individual agencies with respect to data collection and analysis in particular. But I think it is working pretty well, and I think one of the real side benefits of FSOC has been it has enabled us to develop much stronger bilateral relationships within FSOC as well, and Dodd-Frank has done that because of the necessity to write joint rules.

Senator WARNER. Thank you.

Chairman Gensler?

Mr. GENSLER. I would say having witnessed what was its predecessor, the President's Working Group, both in the 1990s—being honored to serve then—and in this Administration, I think it is a real enhancement. It is more formal, and so with formality sometimes there is not as much flexibility, but I think it is a big enhancement. It has not been tested in two ways yet. It really has not been tested in a real crisis again. So, I mean, that has yet to happen. But I think it will serve better than just the old President's Working Group. And it has not truly been tested, as you say, when two agencies have a knock-down, drag-out disagreement. It has been helpful, though, to smooth through some smaller differences, and I think it has been positive in that way.

Senator WARNER. Well, my hope would be that the OFR would be that kind of—at least the data analysis—because my concern is you are going to get data from different agencies coming in that

may be completely counter to each other. And somebody—you have got to have a trusted independent entity in there sorting through that.

I know my time is about up. Let me ask one last question and, again, not directly related to the JPMorgan issue, but, you know, one of the challenges we have on the international implementation is when we have a large American entity that has got a foreign sub and you have got then a foreign counterparty to that American foreign-based subsidiary, and how we deal with the extraterritorial application of U.S. laws, how do we do that *vis-a-vis* foreign laws, you know, what is your state on—what is your sense on the whole international implementation question, and particularly in terms of counterparties, foreign counterparties?

Mr. GENSLER. I think we have made real progress, but there will be differences between Europe, the United States, Canada, Japan, and other jurisdictions. So then you get to this question of cross-border transactions. We are a believer in substituted compliance where we rely on some compliance regime overseas, but we also are a believer in learning from experience. And in 2008, in the three or four biggest circumstances—AIG, Lehman Brothers, Citigroup, Bear Stearns—they all had offshore entities either in the Cayman Islands or in London or branches of French banks in London. And we have to learn from those experiences and not be, excuse me, naive that Wall Street will structure around these things. Some of these large institutions have thousands of legal entities. Long-Term Capital Management was the same. It was in the Cayman Islands, actually, even though it operated out of Connecticut.

So we have to be thoughtful and cover a lot of those transactions and not just leave it to say, well, my guaranteed affiliate will meet your guaranteed affiliate in London, because that is the worst outcome. The risk will all flow back here, but the jobs will move overseas. And that seems like that is a bad place to be.

The second thing, though, I think we can, even if it is our guaranteed affiliate meeting your guaranteed affiliate in London, that still might be that we rely on substituted compliance where we can.

Ms. SCHAPIRO. I would just add that rather than deal with these issues rule by rule, we are going to lay out sort of a comprehensive approach to cross-border application, and we will propose that before we start to adopt final rules other than the definitional rules so that it can inform actually the reach of each and every rule as we go ahead and adopt them. And I think that will give everybody an opportunity to sort of see the entire picture of proposed rules and how we expect them to apply extraterritorially and comment to us on that.

We know foreign regulators have a deep interest in this, and it is a very intense part of the discussion that Gary and I have with our foreign counterparts.

Mr. GENSLER. And I would also add that if an overseas affiliate, not a branch, but if an overseas affiliate is dealing with some insurance company in Germany, we want to make sure that they have a competitive field, that they can compete just like, you know, a Barclays Bank or Deutsche Bank might do as well. So it is trying to get that balance as well.

Senator WARNER. Thank you, Mr. Chairman.

Senator MERKLEY. Thank you, Senator Warner.

Chairman Schapiro, you mentioned twice the list of factors that were essentially the ways to define risk mitigation that were in the Volcker Rule statute, and related issues in there were that you were addressing a specific risk, that it is correlated, and it does not give rise to significant exposure that you did not have to begin with. And often if you think about, for example, a company that has funds in between making loans under the liquidity rule and chooses to do some corporate bonds, assuming those will be allowed, then the first easiest thing, if you get worried about the quality of those bonds, which had been described as kind of extraordinarily high-quality bonds, but you get worried about it, you can reduce your exposure just by selling the bonds. So that is strategy one.

Strategy two is you can take insurance directly against those bonds. That is certainly specifically insurance on a specific position you have.

Then you start getting further and further afield. You can kind of imagine this spectrum of positions that are further afield where then you choose to do an index rather than insure the specific bonds that you have. And then you choose to do a particular tranche in the waterfall, and then you decide you need to raise income to pay for your insurance, so you sell some insurance against something else.

At that point, it seems to me you have clearly crossed the line in which you have introduced by selling insurance to others. You are in a whole different world of risk introduction.

So you have these two components being correlated to begin with and not introducing additional risk. Part of the challenge of the regulators is to kind of define this world. One of you cross the line from risk mitigation to simply having an excuse to do hedge fund-style trading.

Where do you see that line being drawn in that kind of progression of tightly correlated direct insurance to remotely correlated?

Ms. SCHAPIRO. Well, I agree with you it is a continuum, and there are very plain vanilla ways to hedge, and those may even be more or less perfect hedges, and then there is a long continuum to something like portfolio hedging or maybe perhaps stepping off the hedging bandwagon entirely and being in the world of prop trading or speculating. And I think—we recognize that all hedges will not be perfect and that this is a continuum, and finding that point will be difficult. I think that is what the metrics are designed to help us do, and we proposed lots of metrics, and Senator Toomey mentioned some of them. I do not think there is an expectation that all of those will make it into the final rule. But the goal there is to help us see how behavior changes over time within a firm, how transactions change over time as a way to see whether things that are hedging are moving into a different realm.

But that is clearly the difficult piece of this, is to find where something is no longer a hedge and how we can define that, and not in so specific a way that we have just opened the door to lots of other conduct.

Senator MERKLEY. Would you say that it would be a red flag if—I will give you some examples. One, if the hedges only loosely cor-

related when there was a tightly correlated instrument available, would it be a red flag if you are buying insurance to insure a larger quantity than you actually are holding? And would it be a red flag if you are suddenly in the business of selling insurance?

Ms. SCHAPIRO. It might well be because then you have got a hedge transaction that is giving rise potentially to significant exposures that were not there at that inception because you have overhedged the position.

You have to be able, it seems to me, to identify the positions that are being hedged and demonstrate that the hedge is, in fact, risk reducing. And to me, I keep going back to—and you and I have talked about this—the risk mitigation is an important piece of how we are describing the hedging here. But I think if you take all those factors together, you can build a pretty strong wall around this conduct.

Senator MERKLEY. One of the things that Senator Levin and I had said on the floor in our colloquy was you really need—and you just said it so I want to re-emphasize it. You need to identify the specific assets, and you need to identify the specific risk that you are hedging, so that then at least gives the regulators a sense of, well, what was this trade all about. If you cannot identify the risk that you are hedging, then it is very hard to get your hands around it whether was appropriate or not.

Ms. SCHAPIRO. Right, and I think to Senator Toomey's point, that does not mean it has to be positioned—extraordinarily expensive to hedge and counterproductive, frankly, to hedge position by position. But there is something between position by position and complete speculation.

Senator MERKLEY. Chairman Gensler?

Mr. GENSLER. I said earlier I think this is one of the more challenging tasks that the regulators have been given, to ban, prohibit proprietary trading, permit market making, permit hedging

To your question about hedging, I think hedging really does have to lower risk. That is what Congress wanted, I think, in this provision. And they come and they do overlap. I mean, it is not a perfect circumstance. So it is our challenge amongst the regulators to do as Congress said, to say if it is hedging a specific risk, individual or aggregate positions, but it should be—we put in the rule proposal "reasonably correlated." Maybe that word "reasonably" needs more definition. I think that it can start to morph and mutate when you have a separate desk and they have a separate profit and loss and they are motivated at times to take on positions or even swing for the fences for a little bit of the extra potential for that desk to have profits.

My own experience on Wall Street is long ago, but I will say that when I saw these desks, they sometimes worked for 18 to 24 or 36 months, and then they usually took a big loss, and then they would be maybe shut down. Then several years later, they would sort of come up again. I might be old-fashioned. I liked it when you could tie the hedge somewhere reasonably to the positions.

Senator MERKLEY. Well, indeed, that word "reasonably" is in the statute, and the reason it was put there is because the word "correlated" by itself would suggest that something could be barely coordinated and meet the—or correlated and meet the test. So it did

place the—you know, the challenge to the regulators is define "reasonably." But it certainly was in all of the conversation meant to identify the specific risk and have something as directly related to insuring against that risk or hedging that risk as possible.

Senator Warner, did you want to take an additional time period? We have each had our second period.

Senator WARNER. I will just add one question I was——

Senator SHELBY. No, go ahead. Let him go.

Senator WARNER. Are you sure?

I was interested in the line that Senator Merkley was pursuing because I do think it is where the rubber hits the road. What is reasonable? What is that connectivity? In a certain sense, it may be—you know, if we were going to have an incident like this, it could be a blessing that it was happening with the strongest financial institution we have in the country, and thank goodness we already have in place higher capital requirements, so there is not a systemic risk or a risk to the institution, at least at this point. But I do want to get to the point of liquidation and how it relates to derivatives a little bit.

One of the things—thank goodness, the case that Senator Merkley was talking about did not result in an institution going down, but one of the things I think we all worked very hard together—and actually, Senator Shelby, on Title I and II we got 85 votes on your and Senator Dodd's approach on that—was to make sure that any institution that goes into liquidation, while we maintain the systemic important parts, the institution is liquidated. And while neither one of your agencies is going to be—and we do not have taxpayer support, and that while neither one of your agencies is going to be directly involved in that liquidation process, clearly the question of how you clear and handle the derivatives that might be involved in that institution, the swaps, is an issue that is terribly important. I would just be curious, you know, how you are doing on thinking through that portion of the liquidation process.

Mr. GENSLER. I think that central clearing does help that. In these credit default swap indices, there is central clearing currently just dealer to dealer. So the dealers facing a hedge fund are not yet in, and I think that will help a lot.

We have spent a lot of time at the CFTC with the FDIC on Title II just to give them advice and thoughts on it. I think the most challenging piece is on the swaps that are not cleared because they still leave this tangled web of interconnectedness, and that is why it is so critical, we also think, to get the margin rules right, the dealer-to-dealer, particularly that there is margin being collected—not against the commercial end users—I always have to say that—but between the financial institutions and particularly between the dealers.

Senator WARNER. And you think you are—are you dealing with both FDIC and the Fed on this?

Mr. GENSLER. Yes, and we have had some even, I will call them colloquially, "tabletops" where we take hypothetical—not a real company, but we sort of think it through.

There is a challenge in one provision in Title II with the uncleared swaps, the stay provision, and if they are stayed for a day, you might remember——

Senator WARNER. I do remember that——

Mr. GENSLER.——worked on that.

Senator WARNER. Very much.

Mr. GENSLER. What uncertainty would be in the market. It seems that these weekends, everything is challenging to get it done before the Japan or Australia opens, which is Sunday around 5 o'clock. But then there might be this 24-hour stay in the uncleared swaps, and that is an interesting set of challenges I hope I never face.

Senator WARNER. Chairman Schapiro.

Ms. SCHAPIRO. I really agree with what Chairman Gensler said.

Senator WARNER. Thank you, Mr. Chairman.

Senator MERKLEY. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I have a few observations. Do both of you agree that you cannot take risk out of a marketplace?

Mr. GENSLER. Absolutely. Risk is part of a marketplace and these large financial institutions help our society manage that risk.

Senator SHELBY. Right, right.

Do you agree with that?

Ms. SCHAPIRO. You cannot take it out, and we should not try.

Senator SHELBY. OK. So if you micromanage what entities are doing—for example, JPMorgan. JPMorgan is a huge bank. Obviously, it would be hard to micromanage them to begin with. But if they have got capital and if it is no risk to the taxpayer—I was thinking about what Senator Toomey was talking about, which I associate my remarks with—I do not know of any—I have said it here for years—bank or financial institution that has been well capitalized, first; second, well managed and well regulated that has gotten in trouble. I do not know of any. If you have got one, tell us about it.

So capital I believe is number one, to make sure that the banks are adequately capitalized. And I guess it is up to you to determine the difference between speculation and investment. It might be hard at times. I probably could recognize it if I saw it, but maybe not, because somebody might be speculating and call it an investment. I do not know how you get around that. But I do believe that you cannot take risk out of the marketplace, and I hope you as regulators will not try to do that.

Mr. GENSLER. I agree with that, but I would hope—if I can one more time say I think the transparency—the more transparent markets are, it is harder to misunderstand the risks that you have. The risk gets priced in a marketplace, and it might not be pleasant. I might be actually quite painful at times. But if you are well managed and you say, look, that risk is being priced differently than I thought, I am just going to have to eat my beans here and, you know, mark the position differently. Without that transparency, a lot of times things then start to get poorly understood, poorly managed, and so forth.

Senator SHELBY. Well, I agree. We should not let, you should not let institutions that you regulate operate in a dark hole somewhere. They cannot do it.

Thank you, Mr. Chairman.

Senator MERKLEY. Thank you. I think we are on the point of wrapping up. I will——

Senator WARNER. Mr. Chairman, could I just add——

Senator MERKLEY. Senator Warner.

Senator WARNER. I love my friend Senator Shelby, and I agree you cannot take risk out, and I agree capital—but there is some point we can have such high capital standards we make our banks noncompetitive, too. So getting that balance right I do think the leverage ratios, having this view that looks beyond the single institution because, as I think was made mention, many of these institutions have literally thousands of subs. That is why the FSOC having that ability to raise up these issues to some higher level above the silos I think is important. But I could not agree with you more. You cannot take risk out of the marketplace.

Senator MERKLEY. Well, and I would add to that. I would add that if you think about hedge fund-style investing, the aggregation of capital, and it is going to go wherever, the question is not whether it is risky. Yes, of course, it is risky. The question is: Is it going to be subsidized by taxpayer-insured deposits? And the second question is, when occasionally those investments or those bets go bad, whether it is simply going to, if you will, blow up or melt down the investments of the investors or whether it is going to reverberate in a way that affects a broader access to capital by businesses and families. And that is, of course, back to the whole theory of the firewall between traditional deposit-taking/loan-making banking and hedge funds. So I think it is compatible with that notion that you cannot take out the risk.

I thank you all very much for your testimony and for the dialogue and for the Members. Oversight of the derivatives markets remains an important issue for this Committee, and the Committee Members look forward to working with both of you and your agencies to ensure that the implementation of derivatives reform improves protections for the American people and our financial system.

Thank you. The hearing is adjourned.

[Whereupon, at 11:58 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF MARY L. SCHAPIRO

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

MAY 22, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee:

I appreciate the opportunity to testify regarding the Securities and Exchange Commission's ongoing implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").

As you know, Title VII creates an entirely new regulatory regime for over-the-counter ("OTC") derivatives. To that end, it directs the Commission and the Commodity Futures Trading Commission ("CFTC") to write a number of rules necessary to implement the statutory regime. Since the Dodd-Frank Act was enacted in July 2010, the Commission has proposed most of the rules required by Title VII. We are continuing to work diligently to implement all provisions of Title VII, and to coordinate implementation with the CFTC and our fellow regulators overseas.

My testimony today will provide an overview of these efforts to implement Title VII, emphasizing the Commission's activities since I last testified before this Committee on Dodd-Frank Act implementation in December.

Background

Title VII of the Dodd-Frank Act

Title VII of the Dodd-Frank Act mandates the oversight of the OTC derivatives marketplace and requires that the Commission and the CFTC write rules that address, among other things, mandatory clearing, the operation of security-based swap and swap execution facilities and data repositories, capital and margin requirements and business conduct standards for security-based swap and swap dealers and major participants, and regulatory access to—and public transparency for—information regarding security-based swap and swap transactions.

Under the Dodd-Frank Act, regulatory authority over swaps is divided between the Commission and the CFTC. The law assigns the Commission the authority to regulate "security-based swaps." The CFTC, on the other hand, has primary regulatory authority over "swaps," which represent the overwhelming majority of the overall market for over-the-counter derivatives subject to Title VII.

With respect to the Commission's efforts, this series of rulemakings is designed to improve transparency and facilitate the centralized clearing of security-based swaps, helping, among other things, to reduce counterparty risk. It also is designed to enhance investor protection by increasing disclosure regarding security-based swap transactions and helping to mitigate conflicts of interest involving security-based swaps. By promoting transparency, efficiency, and stability, this framework is intended to foster a more nimble and competitive market.

Ongoing Regulatory Coordination with the CFTC and Other Regulators

In implementing Title VII, our staff is in regular contact with the staffs of the CFTC, Federal Reserve Board, and other financial regulators. In particular, Commission staff has consulted and coordinated extensively with CFTC staff in the development of the joint definitional rules arising under Title VII, including joint rules further defining key terms related to the products covered by Title VII, which we expect to finalize in the near term, and other joint rules further defining certain categories of market participants, which we adopted last month. Although the timing and sequencing of the CFTC's and Commission's proposal and adoption of rules may vary, they are the subject of extensive interagency discussions. As we continue with the implementation of the rules contemplated by Title VII, the objective of consistent and comparable requirements will continue to guide our efforts.

The Dodd-Frank Act also specifically requires that the Commission, the CFTC, and the prudential regulators "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards" with respect to the regulation of OTC derivatives.

Accordingly, the Commission is actively working on a bilateral and multilateral basis with our fellow regulators abroad to address the regulation of OTC derivatives.

Through these discussions and our participation in various international task forces and working groups, we have gathered extensive information about foreign regulatory reform efforts, identified potential gaps, overlaps and conflicts between United States and foreign regulatory regimes, and encouraged foreign regulators to develop rules and standards complementary to our own under the Dodd-Frank Act. Such efforts include frequent communications and meetings with the European Union and other major foreign regulatory jurisdictions in Asia and North America.

Representatives from the Commission also participate in the Financial Stability Board's Working Group on OTC Derivatives Regulation, of which a Commission representative serves as one of the co-chairs on behalf of the International Organization of Securities Commissions ("IOSCO"), and a Commission representative serves as one of the four co-chairs of the IOSCO Task Force on OTC Derivatives Regulation. In addition, representatives from the Commission, the CFTC, and a number of international regulators have met twice, most recently this month, to address cross-border issues related to the implementation of new legislation and rules to govern the OTC derivatives markets in their respective jurisdictions.

As we continue with the adoption of the Title VII rules, we remain committed to consulting with other regulators at home and abroad in an effort to foster the development of common frameworks and to help ensure a level playing field for market participants.

Next Steps for Implementation of Title VII

In the near term, the Commission expects to complete the last of the core elements of our proposal phase, in particular, rules related to the financial responsibility of security-based swap dealers and major security-based swap participants. We also expect to complete our joint rulemaking on the product definitions with the CFTC in the very near term. Final product definitions will help inform derivatives market participants what products would be subject to the new swap and security-based swap requirements, which we view as a crucial step in establishing the Title VII regulatory regime. Importantly, the adoption of final product definitions will not trigger compliance with any rules the Commission is adopting under Title VII, or related statutory requirements. Instead, the compliance dates applicable to specific rules adopted by the Commission under Title VII, and related statutory requirements, will be set forth in those final rules.

The Commission also is continuing to develop a policy statement regarding how the substantive requirements under Title VII within its jurisdiction will be put into effect. This policy statement would be designed to establish an appropriate and workable sequence and timeline for the implementation of these rules. As a purely practical matter, certain of these rules will need to go into effect before others can be implemented, and market participants will need a reasonable, but not excessive, period of time in which to comply with the new rules applicable to security-based swaps. This statement should give market participants a degree of clarity as to how the Commission, in general, is thinking of ordering the compliance dates of the various sets of rules under Title VII. We intend to publish this policy statement for public comment in the very near term.

Additionally, because the OTC derivatives market has grown to become a truly global market in the last three decades, we are continuing to evaluate carefully the international implications of Title VII. The development of our cross-border approach is being informed by our discussions with the CFTC and our fellow regulators in other jurisdictions.

Rather than deal with the international implications of Title VII piecemeal, we intend to address the relevant issues holistically in a single proposal. The publication of such a proposal is intended in part to give investors, market participants, foreign regulators, and other interested parties an opportunity to consider as an integrated whole our proposed approach to the registration and regulation of foreign entities engaged in cross-border transactions involving U.S. parties. The Commission therefore anticipates that this release will be published prior to the finalization of the rules discussed therein so that the comments received can be taken into account in drafting the final rules.

The application of Title VII to cross-border transactions raises a substantial number of complex issues. Among other things, it requires consideration and appreciation of foreign regulatory frameworks and of competition concerns. This is not an easy task. However, I believe that the publication of a fully developed, comprehensive SEC proposal to address these issues, and the opportunity for all interested parties to comment on this proposal, will significantly advance the level of understanding, and greatly facilitate public dialogue, on these issues.

Title VII Implementation to Date

Adoption of Entity Definitions Rulemaking

Since I last testified before this Committee on Dodd-Frank Act implementation, the Commission has adopted final rules and interpretations jointly with the CFTC that further define the terms "swap dealer", "security-based swap dealer", "major swap participant", "major security-based swap participant", and "eligible contract participant". In developing these definitions, the Commission was informed by existing information regarding the single-name credit default swaps market, which will

constitute the vast majority of security-based swaps. The finalization of the entity definitions rulemaking is a foundational step toward the complete implementation of Title VII.

The entity definitions rulemaking defines the term "security-based swap dealer" and adopts interpretations providing guidance as to how the dealer-trader distinction applies to activities involving security-based swaps. This guidance describes what constitutes dealing activity and distinguishing dealing from nondealing activities such as hedging.

The rulemaking also implements the Dodd-Frank Act's statutory *de minimis* exception to the security-based swap dealer definition in a way that is tailored to reflect the different types of security-based swaps. To do so, the rulemaking exempts those entities or individuals who engage in dealing activity in security-based swaps below a certain notional dollar amount over a 1-year period. The rule includes a phase-in of the exemption over time in a way that promotes the orderly implementation of Title VII.

In establishing who is a security-based swap dealer, Title VII gave us the task of identifying those entities that engage in dealing activity in security-based swaps. Title VII does not require most market participants that engage in security-based swaps—such as mutual funds and pension funds—to be regulated as dealers. In addition, Title VII calls for only those dealers acting above a *de minimis* level to be regulated as dealers. We followed the statutory language to bring dealers acting above a *de minimis* level under the Commission's direct oversight, and in so doing we have ensured that the vast majority of notional dealing activity in this market will be subjected to the SEC's Title VII dealer regulatory regime.

Additionally, the rulemaking implements the Dodd-Frank Act's "major security-based swap participant" definition through the use of three objective tests.

The analysis of single-name credit default swap data conducted by the Commission's Division of Risk, Strategy, and Financial Innovation was especially informative in the development of this rule. This analysis provided critically important information regarding potential dealing activity in the credit default swap market, which helped the Commission shape the final rules and evaluate the economic consequences of these rules. Nonetheless, the Commission has directed the staff to report to the Commission on whether changes are warranted to the rules based on an analysis of data after relevant provisions of Title VII are implemented. This report stems, in part, from the fact that the entity definition rules were developed based on our understanding of the existing market and currently available data. The report—together with the associated public comment—is intended to help the Commission thoroughly evaluate the practical implications and effects of the entity definition rules following the regulation of dealers and major participants pursuant to Title VII, using data reflective of the newly regulated market.

Although the entity definition rules technically will be effective in the near term, security-based swap dealers and major security-based swap participants will not be required to register with the Commission until the dates provided in the Commission's final rules for the registration of security-based swap dealers and major security-based swap participants, which are to be adopted at a later point in time.

Additional Actions

The Commission staff continues to work diligently to develop recommendations for the Commission to adopt final rules in each of the twelve areas required by Title VII where rules have been proposed:

- Joint rules with the CFTC regarding further definitions of the terms "swap," "security-based swap," and "security-based swap agreement;" the regulation of mixed swaps; and security-based swap agreement recordkeeping;
- Rules prohibiting fraud and manipulation in connection with security-based swaps;
- Rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps that would lay out who must report security-based swaps, what information must be reported, and where and when it must be reported;
- Rules regarding the obligations of security-based swap data repositories that would require them to register with the Commission and specify the extensive confidentiality and other requirements with which they must comply;
- Rules relating to mandatory clearing of security-based swaps that would establish a process for clearing agencies to provide information to the Commission about security-based swaps that the clearing agencies plan to accept for clearing;

- Rules regarding the exception to the mandatory clearing requirement for hedging by end users that would specify the steps that end users must follow, as required under the Dodd-Frank Act, to notify the Commission of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement;
- Rules regarding the confirmation of security-based swap transactions that would govern the way in which certain of these transactions are acknowledged and verified by the parties who enter into them;
- Rules defining and regulating security-based swap execution facilities, which specify their registration requirements, and establish the duties and implement the core principles for security-based swap execution facilities specified in the Dodd-Frank Act;
- Rules regarding certain standards that clearing agencies would be required to maintain with respect to, among other things, their risk management and operations;
- Rules regarding business conduct that would establish certain minimum standards of conduct for security-based swap dealers and major security-based swap participants, including in connection with their dealings with "special entities," which include municipalities, pension plans, endowments and similar entities;
- Rules regarding the registration process for security-based swap dealers and major security-based swap participants; and
- Rules intended to address conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.

To facilitate clearing of security-based swaps, the Commission adopted final rules providing exemptions for security-based swaps transactions involving certain clearing agencies satisfying certain conditions. We also readopted certain of our beneficial ownership rules to preserve their application to persons who purchase or sell security-based swaps.

Moreover, the Commission took a number of steps to provide legal certainty and avoid unnecessary market disruption that might otherwise have arisen as a result of final rules not having been enacted by the July 16, 2011, effective date of Title VII. Specifically, we have:

- Provided guidance regarding which provisions in Title VII governing security-based swaps became operable as of the effective date and provided temporary relief from several of these provisions;
- Provided guidance regarding—and where appropriate, interim exemptions from—the various pre-Dodd-Frank provisions that would otherwise have applied to security-based swaps on July 16; and
- Taken other actions to address the effective date, including extending certain existing temporary rules and relief to continue to facilitate the clearing of certain credit default swaps by clearing agencies functioning as central counterparties.

Conclusion

The Dodd-Frank Act provides the Commission with important tools to better meet the challenges of today's financial marketplace and fulfill our mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As we continue with implementation of Title VII, we look forward to continuing to work closely with Congress, our fellow regulators both home and abroad, and members of the public. Thank you for the opportunity to share our progress on the implementation of Title VII. I will be happy to answer any questions.

PREPARED STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

MAY 22, 2012

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 commit-

ment 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 benefited 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 har-

monize 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 commingling) 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 Web site 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 nonfinancial 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 nonfinancial 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 benefited 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 2 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 2-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 fu-

tures 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 4 years after the financial crisis and 2 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.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM GARY GENSLER

Q.1. Chairman Gensler, during the week leading up to the bankruptcy of MF Global, how many times did you brief the other Commissioners on the CFTC's management of the crisis? Please explain.

A.1. During the week of October, 24, 2011, as MFG's financial condition deteriorated, CFTC staff became involved in monitoring the firm's financial condition. During that week, the other Commissioners and I were briefed by Commission staff about ongoing developments, including during the Commission's senior staff briefing on Wednesday and its surveillance meeting on Friday.

Q.2. Chairman Gensler, during the week leading up to the bankruptcy of MF Global, at any time did you indicate to the other Commissioners or CFTC staff that you were concerned about customer assets at MF Global? Please explain.

A.2. Yes. During that week and increasingly over the last weekend of October, I was involved in discussions with other regulators regarding the developments. During some of the calls with regulators on October 29–30 and into the morning of October 31, MFG representatives and representatives of a firm considering facilitating the transfer of MFG customer positions also participated. As of October 28, my understanding from staff at the time was that MFG was not reporting a deficiency, under CFTC regulations, in the customer funds accounts. Given the firm's deteriorating financial condition, however, we requested certain detailed back-up documentation regarding the segregated customer funds under section 4d of the Commodity Exchange Act and secured funds under Part 30 of the Commission's regulations. We pressed for the information over the course of the weekend. Even though the firm had provided some summary information, the firm's failure to provide the requested detailed supporting information was a source of concern to me. My involvement was in furtherance of the CFTC's effort to ensure to the maximum extent possible the protection of customer property that had been entrusted to MFG.

Q.3. Chairman Gensler, in an attempt to justify your MF Global recusal, you stated that you did not want your relationship with MF Global CEO Jon Corzine to "be a distraction."

- Why were you not concerned that your relationship with Mr. Corzine would be a distraction from any previous matter involving MF Global?
- Prior to the MF Global bankruptcy, Mr. Corzine had met with you on matters related to Rule 1.25, which regulates the investment of customer segregated funds. Why did you not recuse yourself from those conversations?

A.3. In keeping with the consistent advice of our General Counsel and Alternate Designated Ethics Officer, I participate in all rulemakings, including Rule 1.25, as they are matters of general applicability. I was advised by the Commission's General Counsel that I was not required to withdraw from participation. However, as it turned to a specific enforcement matter that could involve not just the company but specific individuals, including Jon Corzine, I informed the General Counsel of my decision on November 3 that I would not participate. My decision was in order to ensure that my participation did not serve as a distraction from the Commission's important duties to locate customer funds and conduct an enforcement matter. Subsequently, I executed a "Statement of Non-Participation" to document my decision.

Q.4. Chairman Gensler, you have stated that you "will not participate in any enforcement-related matters involving MF Global and any matter directly related thereto." This language appears to prohibit you from participating in any of the CFTC's efforts to develop recommendations based on lessons learned from the collapse of MF Global. In your absence, who is leading the CFTC's efforts to develop recommendations based on lessons learned?

A.4. I have tremendous confidence in the ability of my fellow Commissioners and the Commission's dedicated staff to develop appropriate recommendations based on lessons learned. With respect to the matters in which I am not participating, Commissioner Jill Sommers is exercising the Commission's executive and administrative functions that otherwise would be exercised by the Chairman in accordance with section 2(a)(6) of the Commodity Exchange Act. In keeping with the consistent advice of our General Counsel and Alternate Designated Ethics Officer, I participate in all rulemakings, as they are matters of general applicability.

Q.5. Chairman Gensler, in Chairman Schapiro's written testimony from the hearing on May 22, 2012, she said that the SEC will publish an implementation plan for their Dodd-Frank derivatives rules and allow the public to comment on it. Will you commit to publishing the CFTC's implementation plan for the Dodd-Frank derivatives rules and allow the public to comment on it?

A.5. The Commission has taken a number of actions to facilitate implementation of Dodd-Frank regulations. These include:

March 16, 2011—Implementing the Dodd-Frank Act, FIA's Annual International Futures Industry Conference, Boca Raton, Florida. Remarks of Chairman Gary Gensler (as posted on CFTC Web site and including listing of order in which rules might be considered).

April 12, 2011—June 10, 2011—Comment period open (292 written comments filed); Concepts document published as a guide for commenters.

May 2, 2011 and May 3, 2011—CFTC–SEC Staff-led Roundtable Discussion on Dodd-Frank Implementation.

May 4, 2011—Notice published in Federal Register re-opening and extending comment periods (through June 30) in order to "provide interested parties with an additional opportunity to participate in" Dodd-Frank Rulemakings. Also requesting comment on the order in which the Commission should consider final rulemakings.

June 17, 2011—Commission seeks public comment on proposed order to grant exemptive relief from the application of Dodd-Frank Act effective dates.

July 14, 2011—Commission publishes final order providing exemptive relief from effective dates of Dodd-Frank Act provisions in order to facilitate a smooth transition for market participants (expiring on December 30, 2011; extended on Dec. 23, 2011).

September 8, 2011—Outline published of Dodd-Frank Title VII Rules the CFTC May Consider in 2011 and the First Quarter of 2012.

September 8, 2011—The Commission sought public comment on proposed rules specifically to establish schedules to phase in compliance with the swap clearing and trade execution requirement provisions of the Dodd-Frank Act. At that meeting, the Commission also approved a proposed rule to phase in compliance with previously proposed requirements, including the swap trading relationship documentation requirement and the margin requirements for uncleared swaps.

December 23, 2011—Commission publishes amendment to July 14 order extending effective date relief through July 16, 2012.

January 11, 2012—Update of order of consideration of final rules posted on Commission Web site.

July 3, 2012—Commission approves amendment to July 14 order extending effective date relief through December 31, 2012.

July 30, 2012—Final rule published in Federal Register detailed phasing of compliance requirements for swaps subject to mandatory clearing

Individual proposed rules specifically request public comment regarding implementation and sequencing. Examples of such rules include: Reporting, Recordkeeping and Trading Records requirements; Real-Time Public Reporting of Swap Transaction Data; Registration of Swap Dealers and Major Swap Participants; and Protection of Collateral of Counterparties to Uncleared Swaps Commission staff—along with staff from the SEC and other implementing agencies—have conducted a number of roundtables (transcripts available on CFTC.gov):

August 20, 2010—Conflicts of interest in the clearing and listing of swaps

September 14, 2010—Swap Data and Swap Data Repositories

September 15, 2010—Swap Execution Facilities

October 22, 2010—Credit Default Swaps

October 22, 2010—Customer Collateral Protection

December 2, 2010—Disruptive Trading Practices

December 12, 2010—Capital and Margin

June 3, 2011—Protection of Cleared Swaps Customer Collateral

June 8, 2011—Swap Data Recordkeeping and Reporting

June 16, 2011—Definition of Swap Dealer and Major Swap Participant

July 6, 2011—Changes related to Commodity Pool Operators and Commodity Trading Advisors

August 1, 2011—International issues

January 30, 2012—"Available to Trade" Provision for SEFs and DCMs

Feb 29 and March 1, 2012—Roundtables to discuss additional customer collateral protection

May 31, 2012—The Volcker Rule

June 5, 2012—Core Principle 9 for Designated Contract Markets

August 9, 2012—Additional Customer Protections

Q.6. Chairman Gensler, the Dodd-Frank Act includes indemnification provisions that make it difficult, if not impossible, for foreign regulators to obtain information on swap transactions. All five SEC Commissioners support repealing the indemnification requirements. Two CFTC Commissioners agree, saying that the CFTC's recent interpretive guidance does not fix the problem. Do you agree with the seven SEC and CFTC Commissioners that the indemnification provisions should be repealed?

A.6. The CFTC is working to ensure that both domestic and international regulators have access to swap data to support their regulatory mandates. The CFTC adopted proposed interpretative guidance stating the view that foreign regulators seeking access to swap data repositories will not be subject to the indemnification provisions if the trade repository is regulated by foreign law and the data is reported under foreign law. The CFTC requested public comment on all aspects of the interpretative guidance.

Q.7. Chairman Gensler, the SEC's swap entity definition rulemaking contains a lengthy discussion of how they determined that $8 billion is the appropriate *de minimis* level to be regulated as a dealer in the derivatives markets they oversee.

- How did the CFTC determine that the same $8 billion figure is appropriate for the markets that you oversee?
- What credit default swap data did the CFTC use in its analysis?
- What interest rate swap data did the CFTC use in its analysis?
- What commodity swap data did the CFTC use in its analysis?
- What agricultural swap data did the CFTC use in its analysis?

A.7. After reviewing comments received regarding the CFTC and SEC joint proposed rule to further define the terms "swap dealer" and "major swap participant," the Commissions arrived at the determination that, generally, a $3 billion notional value in swaps activity over the prior 12 months represented an appropriate *de minimis* threshold. The amount was based on input from commenters and supported by several rationales, including the estimated size of the domestic swap market. Commenters who addressed the question proposed that the standard be set at a level between $200 million and $3.5 billion in notional amount entered into over a period of 12 months. Data and other market descriptions were provided through written comments as well as through input in roundtable discussions hosted by staffs of the two Commissions, as well as index CDS data provided by the SEC and data contained in the Quarterly Report on Bank Trading and Derivatives Activities issued by the Office of the Comptroller of the Currency. The Com-

missions also determined it to be appropriate to establish a *de minimis* threshold phase-in period during which higher *de minimis* thresholds would apply. During this phase-in period, the joint final rule provides generally for a *de minimis* level of swap dealing activity over the prior 12 months of a gross notional value of $8 billion. The Commissions noted particularly that the implementation of swap data reporting under the Dodd-Frank Act may result in new data that would be useful in confirming the Commissions' determination to establish the $3 billion threshold which applies after the phase-in period.

Q.8. Chairman Gensler, the Depository Trust and Clearing Corporation (DTCC) has made a comprehensive global database of detailed credit default swap transaction and position data available to regulators for more than a year. It is my understanding that all of the financial regulators, except the CFTC, have made use of this data as of the date of the hearing.

- When the press began to report that JP Morgan's London office had taken extremely large positions in credit default swap indexes—which fall under the jurisdiction of the CFTC—why didn't the CFTC immediately begin examining the DTCC data?
- If the CFTC had made use of the DTCC data, would you have had a better line of sight into the JP Morgan trades that are the subject of so much scrutiny?

A.8. The CFTC's Division of Enforcement has opened an investigation related to credit derivative products traded by JPMorgan Chase's CIO. I am unable to provide any specific information about a pending investigation.

Q.9.–1. Chairman Gensler, according to Mr. Corzine's Congressional testimony, he met with you on May 5, 2010 at the CFTC.

- What issues were discussed at that meeting? Who else was present at that meeting?

Q.9.–2. Chairman Gensler, on November 17, 2010, MF Global submitted a comment letter on a CFTC regulation. Five days later, you were a guest lecturer on Government regulation at Mr. Corzine's class at Princeton University.

- Were any of the issues related to MF Global's comment letter discussed at any time while you were at Princeton, inside of class or outside of class? Please explain.

Q.9.–3. Chairman Gensler, according to Mr. Corzine's Congressional testimony, he met with you in December 2010 at the CFTC.

- What issues were discussed at that meeting? Who else was present at that meeting?

A.9.–1.–3. For the convenience of the Committee, I include a document that will address these questions. The included document is a Memorandum detailing my activities prior to my withdrawal from participation in the matter. The document includes details, to the best of my recollection, of contacts with Mr. Corzine.

Insert 1 [Confidential Memorandum follows:]

INSERT 1

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
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Office of General Counsel

CONFIDENTIAL MEMORANDUM

TO: Chairman Gensler

FROM: Dan M. Berkovitz
General Counsel and Designated Agency Ethics Official

John P. Dolan
Counsel and Alternate Designated Agency Ethics Official

DATE: December 13, 2011

SUBJECT: Participation in Matters Concerning MF Global, Inc.

I. Introduction and Summary

Pursuant to 5 C.F.R. § 2635.502, the Commodity Futures Trading Commission (CFTC or Commission) designated agency ethics official (DAEO) has undertaken this review of the participation of CFTC Chairman Gary Gensler in certain CFTC matters regarding MF Global, Inc. (MFGI), a futures commission merchant (FCM) registered with the CFTC. During the 1980s and 1990s Chairman Gensler and the former President and Chief Executive Officer (CEO) of MFGI, Jon Corzine, worked together and were partners at Goldman Sachs (GS), an investment bank.[1]

On November 3, 2011, the General Counsel and DAEO provided Chairman Gensler with an oral opinion that the Chairman was not required to withdraw from participation in MFGI matters as a result of his prior relationship with Mr. Corzine. On that same date Chairman Gensler nonetheless elected to not participate in enforcement matters related to MFGI.[2] Following this

[1] Mr. Corzine resigned as President and CEO of MFGI on Friday, November 4, 2011.

[2] On November 8, 2011, Chairman Gensler executed a "Statement of Non-Participation." This statement explained the Chairman's decision: "With respect to the recent matters involving MF Global, the staff at the CFTC is working hard to recover customers' funds and to find out what happened to the missing customer money and how it happened. The CFTC has a tremendously capable staff and I do not want my participation to be in any way a distraction in this important matter."

decision, the General Counsel and DAEO and ADAEO decided to undertake this review to determine whether Chairman Gensler's participation in matters involving MFGI was appropriate.

Based on the facts and circumstances detailed in this memorandum, and based upon the standards set forth in 5 C.F.R. § 2635.502, this review concludes that Chairman Gensler was not required to withdraw from matters involving MFGI. From a legal and ethical perspective, Chairman Gensler's participation in Commission matters involving MFGI was not improper.

II. Factual Background

A. MF Global, Inc.

Subsidiary of MF Global

MG Global is a financial business comprising a holding company, MF Global Holdings Ltd., a Delaware corporation headquartered in New York City, and a variety of subsidiaries located in the United States and other countries.[3] One of the subsidiaries is MFGI, which is an FCM registered with the CFTC as well as a securities broker-dealer registered with the SEC.[4] According to the Annual Report (SEC Form 10-K) filed by MF Global Holdings Ltd. in May 2011, MF Global is a broker in markets for commodities and listed derivatives and a broker-dealer in markets for commodities, fixed income securities, equities, and foreign exchange.[5]

MFGI Bankruptcy

On October 31, 2011, the Securities Investor Protection Corporation (SIPC) filed an application for the entry of a protective order in the U.S. Bankruptcy Court placing MFGI in liquidation under the Securities Investor Protection Act (SIPA). On that same date, "the Commission's Division of Enforcement opened an investigation into whether the Commodity Exchange Act (CEA) or Commission regulations were violated in connection with MFGI, and the Commission [ ] authorized the Division to issue subpoenas."[6]

In a filing on November 2, the Commission informed the Bankruptcy Court that it "intends to take all appropriate action, within the purview of the Bankruptcy Code and the [CEA], to ensure that customers maximize their recovery of funds and to discover the reason for the shortfall in

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[3] MF Global Holdings Ltd. Form 10-K for fiscal year ended March 31, 2011 at 1, http://www.sec.gov/Archives/edgar/data/1401106/000119312511145663/d10k.htm (accessed November 6, 2011); *see* Disclaimer, MF Global Website, http://www.mfglobal.com/disclaimer (accessed November 6, 2011).

[4] Disclaimer, MF Global Website, http://www.mfglobal.com/disclaimer (accessed November 6, 2011).

[5] MF Global Holdings Ltd. Form 10-K for fiscal year ended March 31, 2011 at 5, http://www.sec.gov/Archives/edgar/data/1401106/000119312511145663/d10k.htm (accessed November 6, 2011).

[6] CFTC Press Release, PR6140-11, November 10, 2011.

segregation."[7]

Key officials

Jon S. Corzine was the Chairman and Chief Executive Officer of MF Global Holdings Ltd. until his recent resignation.[8] According to the MF Global website, Mr. Corzine also is an operating partner at J.C. Flowers & Co. LLC.[9] According to the MF Global website, Mr. Corzine joined GS as a fixed income trader in 1975 and subsequently served as chief financial officer and as chairman and senior partner from 1994 through 1999.[10]

Bradley I. Abelow is the President and Chief Operating Officer of MF Global Holdings Ltd.[11] According to the MF Global website, Mr. Abelow previously was a partner and managing director of GS, where he managed the operations group.[12] Earlier he was responsible for GS's operations, technology, risk, and finance functions in Asia.[13] He joined GS in 1989.[14]

Laurie R. Ferber is the General Counsel of MF Global Holdings Ltd.[15] According to the MF Global website, Ms. Ferber worked for GS for over 20 years beginning in 1987.[16] She held a number of different positions including serving as co-general counsel of the Fixed Income,

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[7] Statement of Commodity Futures Trading Commission in Support of the Trustee's Emergency Motion for an Order Approving the Transfer of Certain Segregated Customer Commodity Accounts of MF Global Inc. and Related Margin and Motion for Expedited Hearing, MFGI Bankruptcy Case, November 2, 2011.

[8] Executive Officers Biography, MF Global Website, http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govManage (accessed November 6, 2011).

[9] Executive Officers Biography, MF Global Website, http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govBio&ID=198970 (accessed November 6, 2011).

[10] *Id.*

[11] Executive Officers Biography, MF Global Website, http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govManage (accessed November 6, 2011).

[12] Executive Officers Biography, MF Global Website, http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govBio&ID=204097 (accessed November 6, 2011).

[13] *Id.*

[14] *Id.*

[15] Executive Officers Biography, MF Global Website, http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govManage (accessed November 6, 2011).

[16] Executive Officers Biography, MF Global Website, http://www.mfglobalinvestorrelations.com/phoenix.zhtml?c=194911&p=irol-govBio&ID=186545 (accessed November 6, 2011).

Currency and Commodities Division and launching and running the economic derivatives business.[17]

J. Christopher Flowers is the founder and executive chairman of J.C. Flowers & Co. LLC, a private equity firm.[18] According to press reports, J.C. Flowers & Co. owns preferred stock in MF Global that, if converted to common stock, would amount to 6% of the total.[19] Also according to press reports, Mr. Flowers worked with Mr. Corzine at GS and later recommended that Mr. Corzine take over as MF Global's chairman and chief executive officer in March 2010.[20]

B. Relationship Between Chairman Gensler and Mr. Corzine[21]

Chairman Gensler's Employment at GS

Chairman Gensler worked at GS from September 1979 until September 1997, when he left to serve as Assistant Secretary of Treasury for Financial Markets.[22] In late 1988, when Chairman Gensler became a partner in the firm, there were approximately 128 partners at GS, including Chairman Gensler and Mr. Corzine.[23]

From his arrival at GS in 1979 until late 1991 or early 1992, Chairman Gensler worked in the Mergers and Acquisitions (M&A) Department.[24] In late 1991 or early 1992, Chairman Gensler and a few other junior partners at the firm were asked to transfer to other departments as part of their career development. The transfers were suggested by Mr. Robert Rubin (the co-Chairman and Co-Senior Partner of GS at the time) and Mr. Corzine (the co-head of the fixed income department (FI) at the time). Mr. Gensler was asked to transfer to FI and agreed.

Chairman Gensler's initial assignment in FI was in the mortgage trading department. In this capacity, he reported to Michael Mortara, who reported to Mr. Corzine and the other co-head of FI, Mr. Mark Winkelman. Chairman Gensler, Mr. Mortara, and Mr. Corzine all worked on the fixed income trading floor.

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[17] *Id.*

[18] J.C. Flowers & Co. LLC: Private Company Information – Business Week, (accessed November 6, 2011) http://investing.businessweek.com/research /stocks/private/snapshot.asp?privcapId=1089967.

[19] JC Flowers Fund Said to See $47.8 Million Loss on MF Global – Businessweek (November 2, 2011), http://www.businessweek.com/news/2011-11-02/jc-flowers-fund-said-to-see-47-8-million-loss-on-mf-global.html (accessed November 6, 2011).

[20] *Id.*

[21] The facts in this section are based primarily upon an interview with Chairman Gensler conducted on November 4, 2011.

[22] Chairman Gensler served as Assistant Secretary for Financial Markets from September 1997 until April 1999, and as Undersecretary of Treasury for Domestic Finance from April 1999 to January 2001.

[23] By 1997, when Chairman Gensler left GS, there were approximately 190-200 partners at GS.

[24] Chairman Gensler spent approximately 6-12 months during the 1983-1984 time period on the equity trading floor as part of a "mobility program."

In January 1993, Mr. Corzine requested, and Chairman Gensler agreed, that Chairman Gensler serve as co-head of fixed income trading in the GS office in Tokyo, Japan. Chairman Gensler served in this position until late 1994. During this two-year period, Mr. Corzine and Mr. Winkelman were Chairman Gensler's direct supervisors.

In the fall of 1994, Chairman Gensler was asked by Mr. Steve Friedman, who was then co-head of GS with Mr. Rubin, to transfer out of FI to be the head of the Operations, Technology, and Finance Division (OTF) in Asia. Chairman Gensler reported to Mr. John Thain, head of worldwide OTF. Shortly thereafter, Mr. Corzine became the Senior Partner of GS and Chairman of the Management Committee.[25]

Chairman Gensler returned to New York in November 1995 to become co-head of Finance. In this position, Chairman Gensler continued to report to Mr. Thain, who continued to report to Mr. Corzine and Mr. Paulson. As co-head of Finance, Chairman Gensler served on various committees of the firm, including the Risk Committee. Mr. Corzine also was a member of the Risk Committee (which had approximately 10-15 members), and sometimes he participated on other committees, too. Chairman Gensler served as co-head of Finance until he left GS in 1997 for the Treasury Department. Prior to leaving GS, Chairman Gensler visited with Mr. Corzine at the latter's apartment to provide departing observations.[26]

After Chairman Gensler Left GS

To the best of his recollection, Chairman Gensler believes he did not see Mr. Corzine for three years after Chairman Gensler left GS.[27] While Chairman Gensler served at Treasury, the only time that he saw Mr. Corzine was in late 2000 or early 2001. Then-Senator-elect Corzine had come to the Treasury Department to visit with Secretary of Treasury Lawrence Summers, and following the meeting with Secretary Summers, Mr. Corzine stopped by to say hello to then-Undersecretary Gensler.

In early 2002, Chairman Gensler volunteered to serve as an advisor to Senator Paul Sarbanes on legislation that eventually was enacted as the Sarbanes-Oxley Act. Senator Sarbanes was Chairman of the Senate Committee on Banking, Housing and Urban Affairs and Senator Corzine was a member of the same Committee. In his role as advisor to Senator Sarbanes, Chairman Gensler occasionally spoke with Senator Corzine about the pending legislation. Chairman Gensler also spoke with Senator Corzine while Chairman Gensler, Senator Sarbanes, and Senator Corzine were on the Senate floor during the consideration of the legislation for final Senate passage.

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[25] Executive functions were shared between Mr. Corzine and Mr. Henry Paulson, who served as Chief Operating Partner and Vice-Chairman of the Management Committee. Mr. Thain reported to Mr. Corzine and Mr. Paulson.

[26] Mr. Corzine subsequently left GS in early 1999.

[27] Chairman Gensler believes that he may have spoken with Mr. Corzine once or twice by telephone while serving at Treasury, but cannot specifically recall any such conversations.

In 2003-2004, Chairman Gensler served as Treasurer of the Maryland State Democratic Party. During the same time, Senator Corzine became head of the Democratic Senatorial Campaign Committee. As a result of their fundraising responsibilities, Chairman Gensler saw Senator Corzine at several political events attended by large numbers of people. This included an event to support the campaign of Senator Kerry for President in 2004, which was attended by approximately 400 others, including other members of Congress.

In 2005, Chairman Gensler was invited to a fundraiser in Washington, DC, for the New Jersey State Democratic Party. Approximately 100 people attended, including both Senator Corzine and the other Senator from New Jersey, Senator Frank Lautenberg. At the time, Senator Corzine was campaigning to be elected Governor of New Jersey. As a participant in the fundraiser, Chairman Gensler contributed $10,000 to the New Jersey State Democratic Party (as he similarly contributed to the State Democratic Party of several other States), which earned him the title of being a "host" of the fundraiser.[28] Chairman Gensler did not see Governor Corzine for another three years.

During the primary season for the 2008 Presidential campaign, Chairman Gensler first served as an unpaid senior advisor to the campaign of then-Senator Hilary Clinton. Chairman Gensler recalls speaking with Governor Corzine on a couple of occasions to answer Governor Corzine's questions about Senator Clinton's positions on various policy issues. Chairman Gensler recalls seeing Governor Corzine at a fundraising event in New Jersey in either August or September of 2008 for then-Senator Obama.

Chairman Gensler's Tenure at the CFTC

Chairman Gensler began serving as Chairman of the CFTC in May 2009. At the time he joined the CFTC, Chairman Gensler determined not to participate in any CFTC matters involving GS.

Shortly after joining MFGI in March 2010, Mr. Corzine met with Chairman Gensler and the Chairman's staff at CFTC headquarters. Mr. Corzine requested the meeting, which Chairman Gensler recalls as a "meet and greet" and that Mr. Corzine did not make any specific requests to Chairman Gensler.

In November 2010, Mr. Corzine asked Chairman Gensler to speak at a seminar at Princeton University that Mr. Corzine was conducting on financial institutions and regulation.[29] Mr. Andrew Ross Sorkin also spoke at this seminar, and Mr. Corzine introduced both of them. Following the seminar, Chairman Gensler joined Mr. Corzine and approximately 15-20 students for dinner.[30] Chairman Gensler and Mr. Corzine did not discuss any issues relating to MFGI while Chairman Gensler was at Princeton.

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[28] Chairman Gensler's contribution was to the New Jersey State Democratic Party, not directly to Senator Corzine's campaign for Governor.

[29] A copy of Chairman's Gensler's speech can be found at: http://www.cftc.gov/PressRoom/SpeechesTestimony/2010/index.htm. (last visited Nov. 6, 2011).

[30] Mr. Sorkin was unable to stay for the dinner.

In December 2010, Mr. Corzine and Ms. Ferber met with Chairman Gensler and other CFTC staff. Chairman Gensler does not recall the subject of the meeting or the matters discussed.

In June 2011, Chairman Gensler was the keynote speaker at lunch at a conference sponsored by Sandler O'Neill and Partners, an investment banking and broker/dealer firm.[31] Mr. Corzine was seated at the same table as Chairman Gensler during the lunch. The invitation did not come from Mr. Corzine, and Chairman Gensler and Mr. Corzine did not discuss any issues relating to MFGI while Chairman Gensler was at the conference.

In September 2011, Chairman Gensler and Mr. Corzine were both wedding guests of mutual acquaintances. Chairman Gensler and Mr. Corzine did not discuss any issues relating to MFGI while attending the wedding.

Chairman Gensler has been on two conference calls with Mr. Corzine during his term as Chairman of the CFTC. The first, on July 20, 2011, was a conference call to discuss topics relating to a rulemaking regarding CFTC Rules 1.25 and 30.7.[32] Second, Chairman Gensler participated in a series of conference calls with other regulatory authorities and MFGI during the days leading up to the filing of the MFGI bankruptcy proceedings. Chairman Gensler is aware that Mr. Corzine was on the line for at least part of one of these calls, regarding the European bond portfolio.[33] Since becoming Chairman of the CFTC, Chairman Gensler has not had any private telephone conversations with Mr. Corzine.[34]

Summary

Chairman Gensler worked with Mr. Corzine during the last 6 years of Chairman Gensler's tenure at GS. During two of those years (1993-1994), Chairman Gensler reported directly to co-heads Messrs. Corzine and Winkelman; during the other four years, Mr. Corzine was his second-level supervisor. Their relationship during this period was solely professional. Chairman Gensler and

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[31] The firm regularly sponsors such conferences. See, e.g., https://register.sandleroneill.com/conferences/ (last visited Nov. 6, 2011).

[32] A record of this call can be found at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/dfmeeting_072011_928 (last visited Nov. 7, 2011). In response to media questions as to whether a delay in consideration of this rulemaking showed favoritism to MFGI, Chairman Gensler has stated that he has "been consistent on this rule, and I allowed more time for others to continue to look at it." *See* Silla Brush, Bloomberg, "MF Global Didn't Get Preferential Treatment, CFTC's Gensler," Nov. 7. 2011.

[33] It is possible that Mr. Corzine was on the line during other portions of these conference calls.

[34] On November 8, 2011, BNA reported that Chairman Gensler and Mr. Corzine spoke shortly after Mr. Corzine resigned from his positions at MF Global. See Steven Joyce, BNA, "Gensler Says Recusal Decision Made Days Before Corzine Resignation, Grassley Letter," Nov. 8, 2011. This report is not accurate; the reported conversation between Chairman Gensler and Mr. Corzine did not occur.

Mr. Corzine did not socialize or spend time together apart from their mutual professional activities.[35]

Since the time they worked together at GS over 14 years ago, Chairman Gensler's contacts with Mr. Corzine have been infrequent. Generally, they have met when they both were present at a function organized by others. Similarly, Chairman Gensler has not socialized with Mr. Corzine after his departure from GS, nor have their families socialized with each other. Chairman Gensler and Mr. Corzine do not correspond with each other; Chairman Gensler does not recall any emails or other electronic communications between himself and Mr. Corzine for at least as far back as ten years. Chairman Gensler does not carry Mr. Corzine's personal phone number in his cell phone directory.

Chairman Gensler and Mr. Corzine have never attended any of each other's major non-professional life-events during the entire time they have known each other. Mr. Corzine did not attend Chairman Gensler's wedding (which occurred while Chairman Gensler was at GS), the bat-mitzvahs of Chairman Gensler's daughters, or the funeral of Chairman Gensler's wife. Similarly, Chairman Gensler did not attend Governor Corzine's inaugural in 2005 or his wedding in 2010.

Chairman Gensler did not ask Mr. Corzine for support of his nomination as CFTC Chairman. He has never contributed directly to any of Mr. Corzine's electoral campaigns. He has raised money for several national Democratic figures, but has never solicited a campaign contribution for Mr. Corzine. Nor does he recall ever soliciting a campaign contribution from Mr. Corzine.

C. Relationship Between Chairman Gensler and Other Former GS Officials Working For or On Behalf Of MFGI[36]

Certain other current MFGI employees and officials previously worked at GS at the same time as Chairman Gensler. Chairman Gensler's relationship with these individuals is as follows:

Brad Abelow

Mr. Abelow became a partner at GS at around the time that Chairman Gensler was leaving GS. At some point, Mr. Abelow became head of OTF in Asia, the position Chairman Gensler had previously occupied. Chairman Gensler recalls that when he was in OTF he and Mr. Abelow had a "weekly to bi-weekly working relationship."

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[35] Chairman Gensler recalls one non-professional interaction that indirectly involved Mr. Corzine during his tenure at GS. In 1991, Chairman Gensler learned that Mr. Corzine had registered to run in the New York City Marathon that year. Chairman Gensler recalls that he asked Mr. Corzine's secretary whether Mr. Corzine actually was going to run the marathon. A few weeks later Mr. Corzine's secretary told Chairman Gensler that Mr. Corzine would not run in the race and would not use the number he had been provided. Mr. Corzine's secretary gave Mr. Corzine's number to Mr. Gensler, who then used Mr. Corzine's bib number in the race.

[36] The facts in this section are based primarily upon an interview with Chairman Gensler conducted on November 4, 2011.

After leaving GS, Chairman Gensler did not see Mr. Abelow until August or September 2008, at a fundraiser for the Presidential campaign of then-Senator Obama. As previously noted, Governor Corzine also attended this event. At the time, Mr. Abelow was Governor Corzine's Chief of Staff. Chairman Gensler recalls speaking to Mr. Abelow for approximately five to ten minutes at this event.

Chairman Gensler believes it is possible that he may have spoken to Mr. Abelow on one or more occasions in his capacity as Governor Corzine's Chief of Staff to facilitate the discussions with Governor Corzine previously noted during the Presidential primary season prior to the 2008 election. After that, Chairman Gensler did not speak with Mr. Abelow again until one of the multi-party conference calls between regulators and MFGI during the weekend prior to the bankruptcy filing of MFGI.

Chairman Gensler and Mr. Abelow did not have a social relationship apart from their professional relationship at GS.

Christopher Flowers

Chairman Gensler began working with Mr. Flowers in the M&A department at GS upon his arrival at GS in 1979. They worked together in M&A for approximately 12 years—until Chairman Gensler was transferred from M&A to FI. While Chairman Gensler was in the M&A department, he and Mr. Flowers frequently discussed M&A issues and strategies, but Chairman Gensler and Mr. Flowers specialized in different industries and, to the best of his recollection, did not work together on any specific deals.

After Chairman Gensler left GS, Mr. Flowers visited him once at the Treasury Department. Chairman Gensler recalls that as part of this visit they may have had lunch together.

Chairman Gensler does not recall seeing Mr. Flowers in person since that meeting at the Treasury Department. Mr. Flowers called Chairman Gensler twice at the CFTC. With respect to the first call, Chairman Gensler recalls that Mr. Flowers expressed condolences that his wife had passed away, and he provided Chairman Gensler with the name of an individual who was knowledgeable about financial market regulation.[37] Mr. Flowers did not ask for any action by Chairman Gensler or the CFTC.

In connection with the MFGI matter, Mr. Flowers called Chairman Gensler on October 31, 2011, before Chairman Gensler arrived at the office. Chairman Gensler returned Mr. Flowers' call after he arrived at the office. Several other CFTC employees were present in Chairman Gensler's office for the call and several individuals were present with Mr. Flowers, including Mr. Goldfield, Henri Steenkamp (Chief Financial Officer) and another MFGI official. The MFGI officials on the call provided the call participants with information regarding MFGI's financial status.

[37] Chairman Gensler did not contact that individual and does not recall his or her name.

Chairman Gensler and Mr. Flowers did not have a social relationship apart from their professional relationship at GS.

Laurie Ferber

At the time that Chairman Gensler was in FI at GS, Ms. Ferber was a senior compliance officer/attorney at the firm. Chairman Gensler believes that he may have spoken with Ms. Ferber on one or more compliance matters when he was in FI, but he does not recall anything specific.

After leaving GS, Chairman Gensler did not have any contact with Ms. Ferber until he met with the Board of Directors of the Futures Industry Association (FIA) in September 2010. At the time, Ms. Ferber represented MFGI on the FIA Board of Directors. Ms. Ferber also attended the meeting between Mr. Corzine and CFTC officials, including Chairman Gensler, in December 2010. Ms. Ferber also was on the July 20, 2011, conference call between MFGI officials (including Mr. Corzine) and CFTC officials, including Chairman Gensler, concerning topics relating to a CFTC rulemaking regarding Rules 1.25 and 30.7. Chairman Gensler does not believe that he met or spoke with Ms. Ferber after that, until she participated in one or more multi-party conference calls between MFGI and regulators prior to the bankruptcy filing.

Chairman Gensler and Ms. Ferber did not have a social relationship apart from their professional relationship at GS.

Jacob Goldfield

Chairman Gensler first met Mr. Goldfield in late 1991 or early 1992, after Chairman Gensler began working in FI. Mr. Goldfield also worked in FI, trading options on the government bond desk.

At the time that Chairman Gensler was co-head of fixed income trading in Tokyo, he also had co-supervisory responsibility for the trading of Yen currency swaps conducted in Asia. At the same time, Mr. Goldfield, who was located in New York, had supervisory responsibility for the worldwide GS swap book. Accordingly, Chairman Gensler and Mr. Goldfield had overlapping responsibilities with respect to the GS Yen swap book. Chairman Gensler recalls that he and Mr. Goldfield also later may have served together on the Risk Committee.

Mr. Goldfield visited Chairman Gensler on one occasion at the CFTC. During the consideration of the Dodd-Frank legislation, Mr. Goldfield met with Chairman Gensler and at least one other member of the Chairman's staff. Mr. Goldfield told the Chairman that he was doing good work and if he ever needed anything, to give him a call. Chairman Gensler does not recall any other meetings with Mr. Goldfield since Chairman Gensler left GS.

On October 30, 2011, Mr. Goldfield e-mailed Chairman Gensler to inform him that he was at MF Global "in case there are questions." Mr. Goldfield also informed Mr. Gensler that he had "no financial interest in the company and [was] not looking at it for investment." Mr. Gensler asked Mr. Goldfield whether there were "any observations you wish to pass along?" Mr. Goldfield replied, "Not as of now, I want only to send along novel insights that are useful." Chairman Gensler responded, "Novel and useful. Now those are limiting conditions, though I

would say that most everything you have shared over our long knowing each other has been useful." Mr.Goldfield then stated, "Also want to make sure that I am right before I comment." Chairman Gensler does not recall any further comments or information from Mr. Goldfield.

Mr. Goldfield was present at MFGI during one of the conferences call between MFGI and regulators on October 30, 2011. To the best of his recollection, Mr. Goldfield did not speak on the call. A participant from another regulatory agency who was present at MFGI headquarters in New York and who was on the call relayed to Chairman Gensler during the call that Mr. Goldfield walked by and requested that he say "hello to Gensler."

Mr. Goldfield also was present at MFGI during a conference call between MFGI and regulators on the morning of October 31, 2011.

Chairman Gensler and Mr. Goldfield did not have a social relationship apart from their professional relationship at GS.

III. Legal Standard

The standard for determining whether an employee may participate in a matter affecting the employee's financial interests, or involving persons with whom the employee has or has had a professional, business, economic, or personal relationship, is set forth in 5 C.F.R. § 2635.502.

Specifically, § 2635.502(a) provides:

> (a) *Consideration of appearances by the employee.* Where an employee knows that a particular matter involving specific parties is likely to have a direct and predictable effect on the financial interest of a member of his household, or knows that a person with whom he has a covered relationship is or represents a party to such matter, and where the employee determines that the circumstances would cause a reasonable person with knowledge of the relevant facts to question his impartiality in the matter, the employee should not participate in the matter unless he has informed the agency designee of the appearance problem and received authorization from the agency designee in accordance with paragraph (d) of this section.
>
> > (1) In considering whether a relationship would cause a reasonable person to question his impartiality, an employee may seek the assistance of his supervisor, an agency ethics official or the agency designee.
> >
> > (2) An employee who is concerned that circumstances other than those specifically described in this section would raise a question regarding his impartiality should use the process described in this section to determine whether he should or should not participate in a particular matter.

With respect to a "covered relationship," § 2635.502(b)(iv) provides that an employee has a "covered relationship" with any person "for whom the employee has, *within the last year*, served

as officer, director, trustee, general partner, agent, attorney, consultant, contractor or employee." (Emphasis added.)[38]

When the circumstances identified in § 2635.502(a) are not present—i.e., there is no direct and predictable effect on the financial interest of a member of his household, and there is no covered relationship—§ 2635.502(a)(2) provides that the procedures specified in § 2635.502 should still be followed if a question concerning the employee's impartiality may nevertheless remain.[39]

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[38] Section 2635.502(b) provides in full that an employee has a "covered relationship" with:

> (i) A person, other than a prospective employer described in § 2635.603(c), with whom the employee has or seeks a business, contractual or other financial relationship that involves other than a routine consumer transaction;
>
> (ii) A person who is a member of the employee's household, or who is a relative with whom the employee has a close personal relationship;
>
> (iii) A person for whom the employee's spouse, parent or dependent child is, to the employee's knowledge, serving or seeking to serve as an officer, director, trustee, general partner, agent, attorney, consultant, contractor or employee;
>
> (iv) Any person for whom the employee has, within the last year, served as officer, director, trustee, general partner, agent, attorney, consultant, contractor or employee; or
>
> (v) An organization, other than a political party described in 26 U.S.C. 527(e), in which the employee is an active participant. Participation is active if, for example, it involves service as an official of the organization or in a capacity similar to that of a committee or subcommittee chairperson or spokesperson, or participation in directing the activities of the organization. In other cases, significant time devoted to promoting specific programs of the organization, including coordination of fundraising efforts, is an indication of active participation. Payment of dues or the donation or solicitation of financial support does not, in itself, constitute active participation.

[39] Under these circumstances—where no financial interest is affected and no covered relationship exists—the Office of Government Ethics (OGE) does not consider the failure to follow these procedures to be "an ethical lapse":

> OGE has consistently maintained that, although employees are encouraged to use the process provided by section 2635.502(a)(2), '[t]he election not to use that process cannot appropriately be considered to be an ethical lapse.' OGE Informal Advisory Letter, 94 x 10(2); *see also* OGE 97 x 8 ('obligation' to follow process where covered relationships involved, but employees 'encouraged' to use process in other circumstances); OGE 95 x 5 ('not required by 5 C.F.R. 2635.502 to use the process described in that section' where there is no covered relationship with person who is a party or represents a party); OGE 94 x 10(1)(employee may 'elect' to use process in section 2635.502(a)(2), but 'election not to use that process should not be characterized, however, as an 'ethical lapse').

"For example," the Office of Government Ethics (OGE) explains, "if an employee believes that a personal friendship, or a professional, social, political or other association not specifically treated as a covered relationship, may raise an appearance question, then the employee should use the section 2635.502 process to resolve the question."[40]

In this event, under the § 2635.502 process, the threshold determination is to "consider whether the employee's impartiality would reasonably be questioned if the employee were to participate in a particular matter involving specific parties where persons, with certain personal or business relationships with the employee are involved."[41] If it is determined that the employee's participation would "raise a question in the mind of a reasonable person about his impartiality," the agency's designated ethics official may nonetheless authorize the employee to participate in the matter "based on a determination, made in light of all relevant circumstances, that the interest of the Government in the employee's participation outweighs the concern that a reasonable person may question the integrity of the agency's programs and operations."[42]

OGE 01 x 8, Impartiality and Romantic Relationships, August 23, 2001. OGE has further indicated that in such circumstances, "even if it were now determined, in hindsight, that a reasonable person with knowledge of the circumstances would question the [person's] impartiality, we cannot say that she violated the impartiality rule." *Id.*

[40] OGE, Memorandum dated April 26, 1999, from Stephen D. Potts, Director, to Designated Agency Ethics Officials, Regarding Recusal Obligations and Screening Arrangements, 99 x 8. Under section 2635.502(a)(2), an employee may determine not to participate in a matter due to appearance concerns even if that employee's withdrawal is not required. *Id.*

[41] *Id.*; 5 C.F.R. § 2635.502(c).

[42] 5 C.F.R. § 2635.502(d). This section provides the following factors that may be considered in making this determination:

> (1) The nature of the relationship involved;
>
> (2) The effect that resolution of the matter would have upon the financial interests of the person involved in the relationship;
>
> (3) The nature and importance of the employee's role in the matter, including the extent to which the employee is called upon to exercise discretion in the matter;
>
> (4) The sensitivity of the matter;
>
> (5) The difficulty of reassigning the matter to another employee; and
>
> (6) Adjustments that may be made in the employee's duties that would reduce or eliminate the likelihood that a reasonable person would question the employee's impartiality.

IV. Analysis

Is there a financial interest or "covered relationship"?

Neither Chairman Gensler nor any member of his household has a financial interest in MFGI, or in any commodity or security interest held by MFGI. More broadly, neither Chairman Gensler nor any member of his household has any other financial interest that would be predictably or directly affected by a CFTC investigation involving MFGI or associated CFTC actions, including participation in the MFGI bankruptcy proceedings, and the recovery of customer funds. Accordingly, the resolution of the MFGI matter would not have a "direct and predictable" effect upon the financial interests of Chairman Gensler or any member of his household. Chairman Gensler does not have a "covered relationship" with MFGI or any of its employees, officers, directors, or shareholders. Chairman Gensler's partnership with GS, Mr. Corzine, and other partners at GS terminated in 1997, more than 14 years ago. This is far beyond the one-year "cooling off period" provided in § 2635.502(b)(iv) for a person who was a general partner with another person to be considered to have a "covered relationship" with such other person.[43]

Is there a reasonable basis to question the employee's impartiality?

The sole fact that Chairman Gensler at one time was a business partner with Mr. Corzine, without more, does not constitute a reasonable basis, within the meaning of § 2635.502, to question Chairman Gensler's impartiality with respect to matters relating to MFGI.

Once the one-year cooling-off period has passed, the fact that an employee previously was within a covered relationship with respect to another individual, without more, cannot by itself be the basis to reasonably question an employee's impartiality. To hold otherwise would, in effect, transform the one-year cooling off period into a lifetime prohibition, for in every such instance the covered relationship within the one-year period could be cited as the basis for disqualification beyond the one-year period.[44]

The ethics regulations do not require such a result. To the contrary, the procedures in § 2635.502 clearly contemplate that employees who at one time may have had a covered relationship with respect to another person or entity, but that no longer have such a covered relationship, may participate in a matter involving the person or entity that previously was within the covered relationship.

To constitute a reasonable basis to question Chairman Gensler's impartiality, therefore, there must be some additional indicia of a relationship between Chairman Gensler and Mr. Corzine, GS, or its partners, beyond the factors that would establish a covered relationship—i.e., facts in

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[43] 5 C.F.R. § 2635.502(b)(iv). As previously noted, OGE has stated that if no financial interest is involved and a covered relationship is not present, a determination not to follow the procedures in § 2635.502—and hence to participate in the matter—cannot be considered to be an "ethical lapse." Nonetheless, in accordance with OGE recommendations, Chairman Gensler has determined to follow the § 2635.502 process.

[44] This conclusion is consistent with the OGE position that in circumstances in which no financial interest is involved and a covered relationship is not present, a determination not to follow the procedures in § 2635.502 cannot be considered to be an "ethical lapse."

addition to Chairman Gensler's partnership at GS some 14 years ago. However, the facts regarding Chairman Gensler's relationship with Mr. Corzine and others at GS who are now associated with MFGI – both during the time that Chairman Gensler worked at GS and afterwards -- are insufficient to provide such indicia.

The record set forth above indicates that at all times, both during their partnership and afterwards, the relationship between Chairman Gensler and Mr. Corzine was exclusively a professional relationship. Chairman Gensler and Mr. Corzine did not socialize or meet apart from their professional obligations and interests. The record indicates that since Chairman Gensler and Mr. Corzine left GS in the late 1990s, they have met only infrequently and solely on matters of mutual professional interest. Indeed, most of their encounters have occurred when they both have been invited to attend an event by others. Although both Chairman Gensler and Mr. Corzine have been involved in political fundraising and electoral campaigning, neither has done so on the other's behalf or at the other's request. They have not socialized, and they have not been involved in each other's personal lives. Their infrequent professional contacts, over a 14-year period following their departure from their partnership at GS, do not constitute a covered relationship or a similar type of relationship that would form a reasonable basis under section 2635.502 to question Chairman Gensler's impartiality with respect to MFGI. [45]

Following his departure from GS, Chairman Gensler's contacts with Mr. Abelow, Mr. Flowers, Ms. Ferber, and Mr. Goldfield have been more attenuated than his contacts with Mr. Corzine. Based on the highly infrequent nature of Chairman Gensler's contacts with these individuals since he left the GS partnership in 1997, Chairman Gensler's relationships with these individuals, both individually and collectively, are insufficient to constitute a reasonable basis under section 2635.502 to question Chairman Gensler's impartiality with respect to MFGI.

In sum, this review determines, based on the facts and circumstances stated herein, that there is not a reasonable basis under 5 C.F.R. § 2635.502 to question Chairman Gensler's impartiality with respect to the Commission's investigation of MFGI and involvement in related matters, such as the MFGI bankruptcy proceedings. Accordingly, 5 C.F.R. § 2635.502 does not preclude Chairman Gensler's participation in these matters, and Chairman Gensler is not required to withdraw from participation. From a legal and ethical perspective, Chairman Gensler's participation in Commission matters involving MFGI would not be improper.[46]

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[45] Chairman Gensler's contribution to the New Jersey State Democratic Party at the time Mr. Corzine was campaigning for Governor of New Jersey is not sufficient to warrant a different conclusion. During this time period, Chairman Gensler was an active fundraiser for and contributor to Democratic candidates for elected office in many states. Chairman Gensler's contribution to the New Jersey State Democratic Party therefore is not sufficient to establish a special relationship between Chairman Gensler and Mr. Corzine that would warrant a different conclusion.

[46] This review solely addresses matters before the Commission prior to and at the time of the Chairman's election not to participate and is based on the facts contained herein.

Q.10. Chairman Gensler, according to a March 1, 2011 MF Global filing at the Securities and Exchange Commission (SEC), the compensation committee of MF Global's board "believes that Mr. Corzine's leadership improved posture with regulators."

How did MF Global's posture improve with the CFTC under Mr. Corzine's leadership?

A.10. I have no information regarding the basis of the statement in the filing.

Q.11.–1. Chairman Gensler, according to Mr. Corzine's Congressional testimony, you gave a luncheon speech at a conference sponsored by the investment firm of Sandler & O'Neill on June 9, 2011. During the question and answer session, Mr. Corzine asked you about proposed changes to Rule 1.25.

- What specific question did he ask? What was your answer?
- Did you have any other discussions about Rule 1.25 with Mr. Corzine?

Q.11.–2. According to a memo posted on the CFTC's Web site, on July 20, 2011, Mr. Corzine called you regarding Rule 1.25. Discussion included "MMMFs, asset-backed and issuer-based concentration limits, counterparty concentration limits, in-house transactions and repurchase agreements with affiliates."

- Please provide more details about the discussion.
- Who else participated on the call?

A.11.–1.–2. For the convenience of the Committee, I include a document (Insert 1 previously referenced) that will address a number of questions. The included document is a Memorandum detailing my activities prior to my withdrawal from participation in the matter. The document includes details, to the best of my recollection, of contacts with Mr. Corzine.

Q.12. Chairman Gensler, according to Mr. Corzine's Congressional testimony, you and Mr. Corzine attended a wedding celebration of mutual friends on September 14, 2011.

Please provide the details of any discussions you had with Mr. Corzine regarding MF Global or CFTC regulation while attending that wedding celebration.

A.12. For the convenience of the Committee, I include a document (Insert 1 previously referenced) that will address a number of questions. The included document is a Memorandum detailing my activities prior to my withdrawal from participation in the matter. The document includes details, to the best of my recollection, of contacts with Mr. Corzine.

Q.13.–1. Chairman Gensler, when did you first learn that Moody's had downgraded MF Global on October 24, 2011? What specific actions did you take based upon the downgrade?

Q.13.–2. Did you have direct conversation, or were you part of conversations, with any firms that were considering buying part or all of MF Global's business over the weekend of October 29, 2011 and October 30, 2011? If so, what was the nature of those conversations, and who was involved?

Q.13.–3. Please provide details (including dates, times, and topics discussed) of the communications (*e.g.,* phone calls, emails, text messages, *etc.*) you had with Jon Corzine, or any of his agents or representatives, or any senior members of MF Global, or any of their agents or representatives, from October 24, 2011 through November 1, 2011.

A.13.–1.–3. During the week of October 24, 2011, as MFG's financial condition deteriorated, CFTC staff became involved in monitoring the firm's financial condition. During that week, the other Commissioners and I were briefed by Commission staff about ongoing developments, including that the firm had been downgraded by Moody's. During that week and increasingly over the last weekend of October, I was involved in discussions with other regulators regarding the developments. During a call with regulators on the evening of October 30, representatives of a firm, Interactive Brokers, considering facilitating the transfer of MFG customer positions also participated. My involvement was in furtherance of the CFTC's effort to ensure to the maximum extent possible the protection of customer property that had been entrusted to MFG. Though it was not always apparent which representatives from MFG were present on calls with regulators over the weekend of October 29–30 and into the morning of October 31, to the best of my knowledge and recollection, Mr. Corzine was on the line for at least part of one of these calls, and discussed matters regarding MFG's European bond positions.

Q.14. Chairman Gensler, over the weekend of October 29, 2011 and October 30, 2011, MF Global employees were trying to reconcile a $900 million under segregation figure. When did you first learn about it?

A.14. I first learned in the early morning hours of October 31, 2011, that the firm was reporting a shortfall in the segregated accounts under section 4d of the Commodity Exchange Act.

Q.15. Chairman Schapiro and Chairman Gensler, under your management, the SEC and the CFTC have been in violation of the law for failing to meet 73 statutory deadlines for rulemaking set by Dodd-Frank.

Can you assure this Committee that your agencies will be in compliance with all applicable Dodd-Frank deadlines that are due by the end of this year? If not, please explain why your agencies are missing so many statutory deadlines.

A.15. The Dodd-Frank Act had a deadline of 360 days after enactment for completion of the bulk of our rulemakings—July 16, 2011. Both the Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. This flexibility has allowed us to approach the rulemaking process thoughtfully—not against the clock. We have coordinated closely with the SEC on these issues. Last year, the CFTC granted temporary relief from certain provisions that would otherwise have applied to swaps or swap dealers on July 16, 2011. The Commission has extended that relief to accommodate its implementation schedule.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CFTC STAFF

Q.1. As I mentioned at the hearing, according to the CME's timeline, a CFTC employee gave two CME employees a disc containing documents to support the October 26, 2011 segregated funds statement on the evening of October 30.

- When did the CFTC receive the disc from MF Global?
- When did the CFTC begin reviewing the documents on the disc?
- What was the result of the review of these documents? Did it show any shortfall?
- What specific actions did the CFTC take after reviewing the documents?
- Could you provide the Committee with copies of the documents on the disc?

A.1. At some point after 5 p.m. CDT, and possibly at approximately 5:30 p.m. CDT, on October 28, 2011, MF Global gave a CFTC employee three computer discs. Staff did not at that time undertake a comprehensive review of the discs. A subsequent review of a larger set of records including the information on the discs reflected a shortfall in the customer segregated funds as of Wednesday October 26, 2011.

Q.2. The CFTC had staff onsite at MF Global's Chicago offices the weekend before the firm's bankruptcy filing.

- What specific steps did your agency take to protect customer assets prior to learning that customer assets were missing?
- What date and time did CFTC staff first learn that there was a possible shortfall in the customer segregated accounts? How did the CFTC staff learn about the possible shortfall?
- What date and time did CFTC staff first learn that there was a definite shortfall in the customer segregated accounts? How did the CFTC staff learn about definite shortfall?
- After you learned of the missing customer assets, what specific steps did your staff take to ensure that additional customer funds were not improperly transferred?

A.2. Between 2 p.m. and 2:30 p.m. CDT, Sunday October 30, 2011, a CFTC employee and MF Global employee had a brief conversation from which the CFTC employee understood there was a deficiency or discrepancy in the segregated account. On October 31, the Securities Investors Protection Corporation with the support of the CFTC and the consent of MF Global initiated a liquidation proceeding under the Securities Investors Protection Act of 1970 (SIPA) to protect the customers of MF Global. In FCM bankruptcies, commodity customers have, pursuant to section 766(h) of the Bankruptcy Code, priority in customer property. If customer property is insufficient to satisfy in full all the claims of customers, Part 190 of the Commission's regulations allows other property of the debtor's estate to be classified as customer property to make up any shortfall.

Q.3. Who is responsible for the protection of commodity customer funds at a futures commission merchant (FCM)?

A.3. Under the Commodity Exchange Act, an FCM must treat all money, securities and property received from a customer as margin for the trades or contracts of that customer as belonging to that customer. Furthermore, all customer money, securities, and property must be separately accounted for and segregated from the FCM's proprietary funds. The FCM cannot use funds deposited by one customer to margin or secure trades for another customer. Commission Regulation 1.20 requires that accounts holding segregated funds be titled specifically to identify the contents of the account as separate from the ownership of the FCM. In addition, FCMs must obtain letters from their depositories acknowledging that the funds deposited in those accounts are customer funds and must be treated as such under the CEA—*i.e.,* such depositories are prohibited from treating them as belonging to the FCM or any person other than the customer. Commission Regulation 1.12 requires FCMs to notify the Commission immediately of any occurrence of under-segregation.

Q.4. As I mentioned at the hearing, according to the CME's timeline, a CFTC employee gave two CME employees a disc containing documents to support the October 26, 2011 segregated funds statement on the evening of October 30.

- When did the CFTC receive the disc from MF Global?
- When did the CFTC begin reviewing the documents on the disc?
- What was the result of the review of these documents? Did it show any shortfall?
- What specific actions did the CFTC take after reviewing the documents?
- Could you provide the Committee with copies of the documents on the disc?

A.4. At some point after 5 p.m. CDT, and possibly at approximately 5:30 p.m. CDT, on October 28, 2011, MF Global gave a CFTC employee three computer discs. Staff did not at that time undertake a comprehensive review of the discs. A subsequent review of a larger set of records including the information on the discs reflected a shortfall in the customer segregated funds as of Wednesday October 26, 2011.

Q.5. What authorities does the CFTC have to protect customer segregated accounts at a futures commission merchant (FCM) during an emergency situation?

A.5. An FCM is required to hold sufficient funds in segregated accounts to meet the aggregate total account balances of each of the FCM's customers trading on designated contract markets. When the firm does not hold sufficient funds in segregation to meet the account balances of each of its customers, the Commission can initiate an enforcement action to freeze the customer segregated accounts at the FCM to prevent the FCM from removing funds without appropriate court approvals. If the FCM also is undercapitalized, Commission Regulation 1.17 provides that the FCM must

transfer customer accounts to another FCM, and cease operating as an FCM. If the FCM can immediately demonstrate to the satisfaction of the Commission that it has the ability to come back into compliance with the minimum capital requirements, the Commission may grant the FCM up to a maximum of 10 business days to achieve compliance without having to transfer customer accounts. It is often preferred in an emergency situation to transfer customer accounts and margin funds from the failing FCM to a financially sound FCM. The transfer of the customer accounts and margin funds may pose less of a disruption to customers than a court order freezing customer accounts.

Q.6. In May 2011, FINRA determined that MF Global had a capital deficiency. MF Global CEO Jon Corzine personally appealed that decision to the SEC. The SEC upheld FINRA's determination and MF Global publicly reported the deficiency in August 2011.

- When did the CFTC first learn that MF Global had a capital deficiency? How did the CFTC learn about it?
- In your view, how effective was the SEC's and CFTC's coordination of the regulation of MF Global?

A.6. The CFTC learned that MF Global had a capital deficiency in or about late August 2011. In particular, MF Global submitted a letter to the Commission dated August 25, 2011 stating that on August 24, 2011 FINRA had advised the firm that its capital treatment of certain repo to maturity transactions should be modified resulting in increased capital requirements under SEC Rule 15c3–1. The letter further stated that the firm had increased its capital prior to being advised of the increased capital requirement by FINRA, and that its excess net capital on August 24, 2011 was approximately $113 million after giving effect to the additional capital requirements for the repo to maturity transactions. By letter dated August 30, 2011, and received by the Commission on August 31, 2011, MF Global stated that on August 29, 2011, FINRA had directed the firm to restate its July 2011 FOCUS Report with the revised capital treatment for the repo to maturity transaction. The restated FOCUS Report was filed with the Commission on August 31, 2011 and showed MF Global to be undercapitalized at the end of July 2011.

Q.7. In December 2009, MF Global settled an enforcement action with the CFTC arising from multiple risk supervision failures.

- Following that enforcement action, what specific steps did you take to ensure that MF Global customer assets were not at risk of being misappropriated?

A.7. The Commission's order imposed a $10 million civil monetary penalty and required MF Global to comply with several undertakings, including enacting policies and procedures to enhance risk monitoring procedures, training, compliance procedures and compliance audit procedures. MF Global was also required to undertake an independent review and assessment. The assessment, among other things, was to review the effectiveness of existing and future risk management, supervisory and compliance policies and procedure at MF Global.

Q.8. MF Global filed its 10–K for the fiscal year ended March 31, 2011, disclosing detailed information about its exposure to European sovereign debt in its repo-to-maturity portfolio. What specific actions did the CFTC take based upon the information contained in MF Global's 10–K?

A.8. MF Global was placed on heightened financial surveillance in March 2008 by its designated self-regulatory organization, the CME. The heightened financial surveillance required MF Global to provide the CME, on a daily basis, with a net capital computation and computations demonstrating its compliance with its obligation to segregate customer funds under Section 4d of the Commodity Exchange Act and to set-aside customer funds for trading on non-U.S. contract markets under CFTC Regulation 30.7. MF Global also filed copies of its daily capital and customer funds calculations with the CFTC. Staff of the CME and CFTC reviewed the daily submissions to assess MF Global's compliance with the CFTC's capital and customer funds protection requirements.

Q.9. On August 31, 2011, MF Global amended its FOCUS report for July to report a capital deficiency of $150 million as of July 31, 2011. What specific actions did the CFTC take based upon the amended FOCUS report?

A.9. The CFTC learned that MF Global had a capital deficiency in or about late August 2011. In particular, MF Global submitted a letter to the Commission dated August 25, 2011 stating that on August 24, 2011 FINRA had advised the firm that its capital treatment of certain repo to maturity transactions should be modified resulting in increased capital requirements under SEC Rule 15c3–1. The letter further stated that the firm had increased its capital prior to being advised of the increased capital requirement by FINRA, and that its excess net capital on August 24, 2011 was approximately $113 million after giving effect to the additional capital requirements for the repo to maturity transactions. By letter dated August 30, 2011, and received by the Commission on August 31, 2011, MF Global stated that on August 29, 2011, FINRA had directed the firm to restate its July 2011 FOCUS Report with the revised capital treatment for the repo to maturity transaction. The restated FOCUS Report was filed with the Commission on August 31, 2011 and showed MF Global to be undercapitalized at the end of July 2011.

Q.10. Please provide the details regarding any discussions of MF Global at any of the Intermarket Financial Surveillance Group's (IFSG's) meetings or calls in 2011, including IFSG's annual meeting on October 19, 2011.

A.10. The IFSG is comprised of securities and futures self-regulatory organizations. Though the CFTC is not a member, CFTC staff did attend the meeting on October 19, 2011. The SEC and FINRA led the discussion of the topic of European sovereign debt and the potential impact on broker-dealers. FINRA discussed how it had reviewed the largest broker-dealers and did not identify any material exposures to European sovereign debt with the exception of MF Global. The SEC also had reviewed the broker-dealers for exposure to foreign sovereign debt, and noted no major concerns (other than MF Global). FINRA also discussed how FINRA and the

SEC had required MF Global to take additional capital charges on its European sovereign debt positions. The capital charges were retroactive to the end of July 2011. MF Global increased its capital in August, when informed of the capital charges. The retroactive application of the charges to the end of July 2011, however, caused MF Global to be undercapitalized as of the end of July 2011. FINRA discussed how it was going to continue to monitor broker-dealer exposure to foreign sovereign debt on an ongoing basis.

Q.11. When did you first learn that MF Global had retained Evercore to explore selling its FCM business? When did you first learn that MF Global had instructed Evercore to explore selling the entire firm?

A.11. CFTC staff do not recall any direct interaction with Evercore partners. However, often in the case of a failing FCM, a preferred option is to accomplish the transfer of customer accounts and margin funds from the failing firm to a financially sound FCM. Such a transfer would normally pose less of a disruption to customers.

Q.12. Over the weekend of October 29, 2011 and October 30, 2011, MF Global employees were trying to reconcile a $900 million under segregation figure. When did CFTC staff first learn about this reconciliation?

A.12. Between 2 p.m. and 2:30 p.m. CDT, Sunday October 30, 2011, a CFTC employee and MF Global employee had a brief conversation from which the CFTC employee understood there was a deficiency or discrepancy in the segregated account.

Q.13. What CFTC staff members were onsite at MF Global on each of the following days?

- Monday, October 24, 2011
- Tuesday, October 25, 2011
- Wednesday, October 26, 2011
- Thursday, October 27, 2011
- Friday, October 28, 2011
- Saturday, October 29, 2011
- Sunday, October 30, 2011
- Monday, October 31, 2011

A.13. Roughly, up to seven CFTC staff members were present at various times at MF Global's offices in Chicago and New York from October 27 to October 30, 2011.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Written Testimony of Public Citizen

Bartlett Naylor, Financial Policy Advocate

Implementing Derivatives Reform: Reducing Systemic Risk and Improving Market Oversight

May 22, 2012

Before the:

The Committee on
Banking, Housing and Urban Affairs
U.S. Senate

The Honorable Tim Johnson, Chair

Chairman Johnson, Ranking Member Shelby, Committee Members and distinguished panelists.

My name is Bartlett Naylor and I am the Financial Policy Advocate for Public Citizen's Congress Watch Division. Public Citizen is a national non-profit and we work to take on powerful interests on behalf of the American public, working to win concrete results for our health and well-being.

I submit the following report: "Forgotten Lessons of Deregulation: Rolling Back Dodd-Frank's Derivatives Rules would Repeat a Mistake that led to the Financial Crisis," by Taylor Lincoln, Research Director of Congress Watch.

As Mr. Lincoln's report explains, there is little dispute that inadequate regulation of derivatives was a major contributor to the financial crisis of 2008. Congress approved important measures in the Dodd-Frank Wall Street Reform Act. But a number of bills proposals threaten to create large oversight-free zones that could allow risky behaviors to flourish.

We've stumbled down this path of deregulation before. We ask the committee members to consider this history as a cautionary tale.

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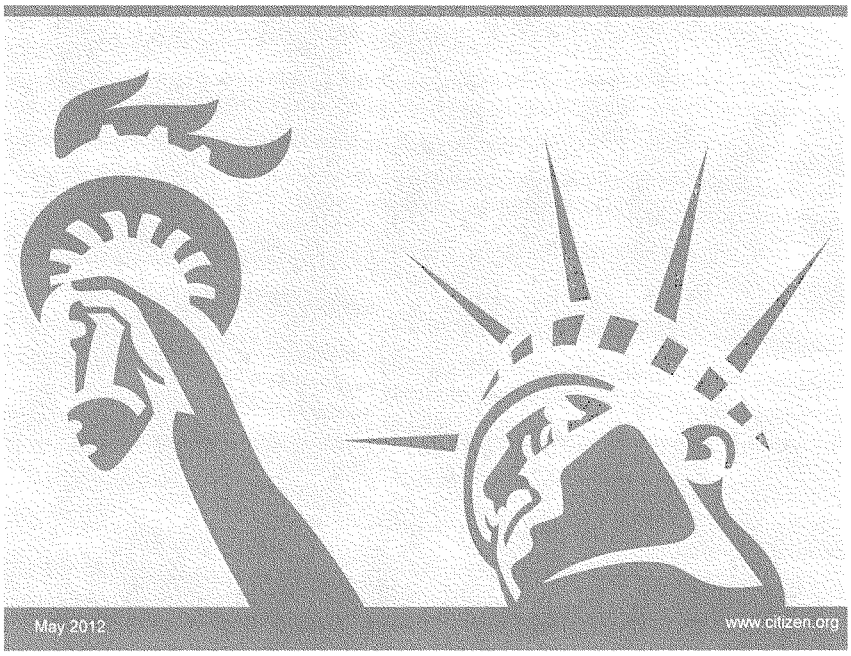

Forgotten Lessons of Deregulation

Rolling Back Dodd-Frank's Derivatives Rules Would Repeat a Mistake that Led to the Financial Crisis

Acknowledgments

This report was written by Taylor Lincoln, Research Director of Public Citizen's Congress Watch division. Congress Watch Financial Policy Advocate Bartlett Naylor provided expert advice. Congress Watch Director David Arkush edited the report.

About Public Citizen

Public Citizen is a national non-profit organization with more than 250,000 members and supporters. We represent consumer interests through lobbying, litigation, administrative advocacy, research, and public education on a broad range of issues including consumer rights in the marketplace, product safety, financial regulation, safe and affordable health care, campaign finance reform and government ethics, fair trade, climate change, and corporate and government accountability.

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> "The sophisticated counterparties that use [over-the-counter] derivatives simply do not require the same protections under the [Commodities Exchange Act] as those required by retail investors."
>
> *—President's Working Group on Financial Markets (1999), consisting of Federal Reserve Chairman Alan Greenspan, SEC Chairman Arthur Levitt, Treasury Secretary Lawrence Summers, and CFTC Chairman William J. Rainer*

Although debate continues over some of the root causes of the 2008 financial crisis, there is little dispute that inadequate regulation of derivatives was a major contributor. In admissions of the sort not often heard in Washington, many of the policy makers who supported derivatives deregulation in the late 1990s now acknowledge that they were wrong. They include former President Bill Clinton, former Federal Reserve Chairman Alan Greenspan, and, with more nuance, two former Treasury secretaries.

In the first decade of the 2000s, derivatives issuers used their regulatory exemption to take enormous risks. Derivatives buyers, in turn, drew a false sense of security from the promises laid out in the contracts they purchased. This illusion of security spurred a lending binge that caused housing prices to soar. After the housing bubble burst, the inability of derivatives issuer American International Group (AIG) to make good on its obligations threatened to cause cataclysmic failures among financial institutions. This was largely responsible for prompting the federal government to authorize hundreds of billions of dollars in bailouts. The combination of the financial crisis and a devastated housing market caused a recession from which the nation has yet to recover.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 addressed many of the shortcomings in derivatives oversight. But, now, at least nine bills are pending in Congress that would erode the derivatives' reforms in Dodd-Frank. Some of these bills seek to exempt large classes of derivatives trades from the law's requirements that such trades be transparent, guaranteed by centralized clearing organizations, and accompanied by adequate collateral. Other bills would impose additional burdens on agencies' ability to promulgate financial services regulations, including those regarding derivatives. Each of the seven derivatives bills introduced in the House of Representatives has at least been approved by a committee and three have passed the full House. [See Appendix] The push to roll back the reforms in Dodd-Frank comes amid news that JPMorganChase, the nation's

largest bank, lost at least $2.3 billion—and may eventually lose more than $4 billion—from recent derivatives trades gone awry.[1]

The effort to exclude certain derivatives trades from public oversight is reminiscent of the campaign to deregulate derivatives in the late 1990s. Americans should reject such appeals this time around.

A. History: At the End of the Clinton Administration, the Federal Government Deregulated Financial Derivatives.

Financial derivatives are instruments "that gain or lose value as some underlying rate, price, or other economic variable changes," according to a definition offered by the Congressional Research Service.[2] Although they are commonly tied to commodities, securities, interest rates, or currency values, derivatives can be based on almost anything, including stock prices, energy prices, or even the weather.[3] Derivatives have traditionally been used to manage risk.

A type of derivative called a swap was developed in the 1980s. Participants in swaps agreed to pay one or the other depending on the fluctuation of an underlying variable.[4] Swaps often performed the same economic function as traditional futures, in which a party agreed to buy a commodity or financial instrument on a specified date.[5] But in contrast to futures, which were traded on regulated exchanges and backed by centralized clearinghouses, swaps began as privately negotiated deals between counterparties and were traded on an unregulated "over the counter," or OTC, basis.[6] Unlike traders using regulated exchanges, the participants in over-the-counter trades relied on each another to make good on their deals.

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[1] Dan Fitzpatrick and Gregory Zuckerman, *Three to Exit J.P. Morgan Drew, Others to Depart in Wake of Loss, Which Could Total More Than $4 Billion*, THE WALL STREET JOURNAL (May 14, 2012), http://on.wsj.com/J49m82.
[2] MARK JICKLING, CONGRESSIONAL RESEARCH SERVICE, THE COMMODITY FUTURES MODERNIZATION ACT (2003), http://bit.ly/JdYBeK.
[3] *See, e.g.*, Bank for International Settlements (BIS), *Semiannual OTC Derivatives Statistics at End-June 2011* (Nov. 2011), http://bit.ly/3ijsbH.
[4] The Commodity Future Trading Commission defined swaps as "an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchanges rates, or prices with payment calculated by reference to a principal base (notional amount)."
[5] For discussion of the similarities of swaps and futures, *see* MARK JICKLING, CONGRESSIONAL RESEARCH SERVICE, THE COMMODITY FUTURES MODERNIZATION ACT (2003) (Swaps "serve the same economic purposes and are often interchangeable" with futures) and Michael Greenberger, *Derivatives in the Crisis and Financial Reform* in THE POLITICAL ECONOMY OF FINANCIAL CRISES 4 (Gerald Epstein & Martin Wolfson eds., Oxford University Handbook, forthcoming) http://bit.ly/yVxUxX ("Swaps contained all the features of a futures contract.").
[6] *See, e.g.*, GENERAL ACCOUNTING OFFICE, THE COMMODITY EXCHANGE ACT, LEGAL AND REGULATORY ISSUES REMAIN 1 (April 1997), http://1.usa.gov/Jb09tp.

The absence of transparency in over-the-counter trading allowed swaps dealers to command more favorable prices. Trading over the counter also enabled dealers to dodge the licensing and margin requirements imposed by regulated exchanges. But because swaps were similar to futures, they were potentially in violation of the CEA's exchange-trading requirement. This left open the possibility that a court would refuse to enforce a swap if a counterparty questioned its legality.[7] Consequently, swaps dealers sought an exemption to the exchange-trading requirement that would give them legal certainty.[8]

The Commodity Futures Trading Commission (CFTC) in 1989 provided an exemption to the exchange-trading requirement for swaps that were individually negotiated and not marketed to the public. But doubt existed over the CFTC's permission under the CEA to offer this assurance. Congress subsequently granted the CFTC such authority. In 1993, the CFTC stipulated that non-standardized swaps negotiated between two parties would be exempt from the exchange-trading requirement.[9]

Still, questions remained over the legality of many over-the-counter swaps. By the mid-1990s, swaps were becoming increasingly standardized, largely due to master agreements provided by the International Swaps Dealers Association (now the International Swaps and Derivatives Association).[10] "OTC derivatives were now so ... standardized that they could be traded electronically on a multilateral basis, thereby exhibiting all of the trading characteristics of traditional exchange traded standardized futures contracts," University of Maryland law professor Michael Greenberger testified to the congressionally appointed Financial Crisis Inquiry Commission (FCIC) in 2010.[11] Greenberger served as director of the CFTC's Division of Trading and Markets in the late 1990s, when questions over regulation of derivatives hung in the balance.

Such standardization raised the prospect that many contracts trading over-the-counter did not meet the terms of the CFTC-issued exemption from the exchange-trading requirement and, thus, could be disallowed.[12] Meanwhile, over-the-counter trading of swaps and other derivatives was soaring. The notional value of over-the-counter derivatives contracts tripled from 1994 to 1997, to more than $28.7 trillion.[13]

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[7] Michael Greenberger, *Derivatives in the Crisis and Financial Reform* in THE POLITICAL ECONOMY OF FINANCIAL CRISES 4 (Gerald Epstein & Martin Wolfson eds., Oxford University Handbook, forthcoming) http://bit.ly/yVxUxX [Hereinafter DERIVATIVES IN THE CRISIS]

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] Testimony of Michael Greenberger to the Financial Crisis Inquiry Commission (June 30, 2010).

[12] DERIVATIVES IN THE CRISIS, at 5-6.

[13] *Commodity Futures Trading Commission, Concept Release CFR Parts 34 and 35, Over-the-Counter Derivatives*, 63 Fed. Reg. 26114, 26115 (issued May 6, 1998) [Hereinafter CONCEPT RELEASE]. Notional value refers to the target price underlying asset to which a derivative is pegged. For instance a barrel of oil may have a notional

> "I have 13 bankers in my office and they say if you go forward with this, you will cause the worst financial crisis since World War II."
>
> *—Assistant Secretary of Treasury Lawrence Summers to CFTC Chairman Brooksley Born on Born's plan to consider increasing regulation of derivatives (1998)*

Instances of investors experiencing wholly unexpected losses in over-the-counter derivatives trades also were increasing. Many such losses were suffered by ostensibly sophisticated investors who did not grasp derivatives' complexity.[14] Most prominently, Orange County, Calif., lost $1.5 billion in derivative investments in 1994 and was forced to file for bankruptcy. Merrill Lynch, which sold the derivatives to the county, eventually paid $400 million to settle claims that it provided deceptive information.[15] Several other large institutions suffered significant losses in derivatives during the 1990s. In many cases, they were able to recoup part of their losses in litigation against the firms that guided them in their investments.[16]

The rising volume of over-the-counter derivatives trades coupled with lingering doubts over their legality created political tension. CFTC Chairman Brooksley Born favored increasing regulation. Industry instead sought a guarantee that derivatives traded over the counter would be excluded from regulation.

Early in 1998, Born contemplated issuing a request for comments on whether the regulatory system for financial derivatives should be altered. She received a telephone call from Lawrence Summers, who was then an assistant secretary of Treasury. "I have 13 bankers in my office and they say if you go forward with this, you will cause the worst financial crisis since World War II," Summers reportedly said.[17]

value of $100. The potential payments for those trading a derivative pegged to the price of a barrel of oil would be the fluctuation between $100 and its actual price.

[14] *Id.*

[15] E. Scott Reckard and Michael Wagner, *Merrill Lynch to Pay $400 Million to Orange County*, THE LOS ANGELES TIMES (June 03, 1998).

[16] CONCEPT RELEASE, at 26115. In footnote 6 of the Concept Release, the CFTC cited a study listing 22 examples of significant losses in financial derivatives transactions and made reference to a 1997 GAO study that identified 360 substantial losses suffered by end-users.

[17] Manuel Roig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On*, WASHINGTON POST (May 26, 2009), http://wapo.st/QIK9f.

> "Diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress."
>
> —*Federal Reserve Chairman Alan Greenspan (1999)*

Born proceeded nonetheless. In May 1998, the CFTC issued a "concept release" seeking comment on whether to alter its largely hands-off approach to financial derivatives trading. The release noted that the over-the-counter derivatives market had experienced "explosive growth" in recent years, with increasing reports of losses, many by investors who did not understand the risks that they were taking.[18]

"Accordingly," the release stated, "the Commission believes it is appropriate at this time to consider whether any modifications ... are needed to enhance the fairness, financial integrity, and efficiency of this market."[19]

Born's release was the opening volley in a highly public debate that she would lose in the halls of Washington, D.C., but ultimately win in the eyes of history. On the same day that the CFTC published its concept release, Greenspan, Treasury Secretary Robert Rubin, and Securities and Exchange Commission Chairman Arthur Levitt Jr. issued a joint statement expressing "grave concerns about this action and its possible consequences."[20]

"We seriously question the scope of the CFTC's jurisdiction in this area and we are very concerned about reports that the CFTC's action may increase the legal uncertainties concerning certain types of OTC derivatives," the three wrote.[21] Greenspan, Rubin and Levitt began pushing for legislation that would impose a moratorium on the CFTC's permission merely to consider changing regulation of derivatives.[22]

The collapse of Long-Term Capital Management in September of that year strengthened Born's case. Long-Term was a hedge fund that had used just $2.2 billion of underlying capital to make $1.25 trillion of investments in derivatives.[23] Turmoil in Russia had roiled the market in ways that Long-Term could not survive. The potential cascading effects of Long-Term's impending losses prompted the New York Federal Reserve to broker a deal

[18] CONCEPT RELEASE, at 26119.
[19] *Id.*
[20] Timothy L. O'Brien, *A Federal Turf War Over Derivatives Control*, THE NEW YORK TIMES (May 8, 1998).
[21] *Id.*
[22] *Senate Temporarily Blocks New Rules on Derivative Securities*, THE NEW YORK TIMES (Oct. 7, 1998).
[23] Joseph Kahn and Peter Truell, *Troubled Investment Fund's Bets Now Estimated at $1.25 Trillion* THE NEW YORK TIMES (Sept. 26, 1998).

whereby a consortium of banks bailed out the fund.[24] The banks infused $3.6 billion in capital in exchange for 90 percent of Long-Terms' stock to avert disaster.[25]

Born said in House testimony that the episode "should serve as a wake-up call about the unknown risks in the over-the-counter derivatives market."[26] But lawmakers did not heed the alarm. Instead, they imposed a six-month moratorium on the CFTC's permission to work on derivatives regulation.[27]

Some even took reassurance from the Long-Term episode. Greenspan, for instance, said it confirmed his "spare tire" theory that "diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress."[28]

Greenspan continued to champion deregulation of derivatives unabashedly. "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives," Greenspan said in a March 1999 speech. "The fact that the [over-the-counter] markets function quite effectively without the benefits of [CFTC regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives."[29]

Born announced her plan to resign in January 1999 and left office in April.[30] In November of that year, the President's Working Group on Financial Markets—consisting of William J. Rainer (Born's replacement as chairman of the CFTC), Summers (who had become secretary of the Treasury), Greenspan and Levitt—issued a report calling for deregulation of the over-the-counter derivatives market to provide "legal certainty" that various activities were exempt from regulation under the CEA. "The sophisticated counterparties

[24] Gretchen Morgenson, *Seeing a Fund as Too Big to Fail, New York Fed Assists Its Bailout*, THE NEW YORK TIMES (SEPT. 24, 1998) and Joseph Kahn and Peter Truell, *Troubled Investment Fund's Bets Now Estimated at $1.25 Trillion*, THE NEW YORK TIMES (Sept. 26, 1998). The General Accounting Office would conclude two years later that the actions by the New York Federal Reserve set a dangerous precedent: "Although no federal money was committed to the recapitalization, FRBNY's intervention raised concerns among some market observers that it could create moral hazard by encouraging other large institutions to assume greater risks, in the belief that the Federal Reserve would intervene to avoid potential future market disruptions." GENERAL ACCOUNTING OFFICE, RESPONSES TO QUESTIONS CONCERNING LONG-TERM CAPITAL MANAGEMENT AND RELATED EVENTS 2 (Feb. 23, 2000), http://1.usa.gov/r9dW0D.

[25] FCIC REPORT, at 57.

[26] Manuel Roig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On*, WASHINGTON POST (May 26, 2009), http://wapo.st/QIK9f.

[27] *Senate Temporarily Blocks New Rules on Derivative Securities*, THE NEW YORK TIMES (Oct. 7, 1998).

[28] FCIC REPORT, at 58.

[29] *Id.*, at 48.

[30] Press Release, Commodity Futures Trading Commission, Chairperson Brooksley Born Announces Her Intention Not to Seek Reappointment to a Second Term (Jan. 19, 1999), http://1.usa.gov/w3bHcr and Manuel Roig-Franzia, *Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On*, WASHINGTON POST (May 26, 2009), http://wapo.st/QIK9f.

that use OTC derivatives simply do not require the same protections under the CEA as those required by retail investors," the report said.[31]

In December 2000, at the end of the Clinton administration, Congress passed the Commodity Futures Modernization Act (CFMA), which almost fully deregulated OTC derivatives trades. The law exempted contract participants with at least $10 million in assets (signifying that they were sophisticated investors) from exchange trading requirements. The law also preempted state laws that might have otherwise prohibited trades that amounted to gambling.[32] President Clinton signed the bill.

Thus, the "multi-trillion dollar OTC derivatives market was removed from almost all pertinent federal and state enforcement to which trading markets had been subject since the New Deal," Greenberger wrote in 2011. "In effect, almost no law applied to this market" after passage of the CFMA."[33]

B. In the Absence of Regulation, the Derivatives Market Pushed the Financial System to the Brink of Collapse.

Over-the-counter derivatives trading grew dramatically in the years following passage of the CFMA. The notional value of such trades, according to the FCIC, increased from $95.2 trillion in 2000 to $672.2 trillion in 2008—a more than seven-fold increase.[34] By contrast, the entire world's assets in 2008 added up to only $178 trillion, according to the McKinsey Global Institute.[35]

It was possible for the value of derivatives trades to dwarf the entire world's wealth in part because multiple derivative positions could to be taken on the same underlying asset—including by people who didn't even own or agree to buy the asset. This would prove particularly disastrous in the case of credit default swaps, a type of derivative that J.P. Morgan & Co. pioneered in the early 1990s and which insurance company American International Group Inc. (AIG) began selling in about 1998.[36] Credit default swaps "insured" securities, such as collateralized debt obligations (CDOs), which consisted of bundled securities, often including bundled subprime mortgages.

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[31] PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS 16 (NOVEMBER 1999).
[32] DERIVATIVES IN THE CRISIS, at 52.
[33] *Id.*, at 10.
[34] FCIC REPORT, at 48.
[35] MCKINSEY GLOBAL INSTITUTE, GLOBAL CAPITAL MARKETS: ENTERING A NEW ERA (SEPTEMBER 2009), http://bit.ly/yRPfB2.
[36] John Lanchester, *Outsmarted: High Finance vs. Human Nature*, THE NEW YORKER (June 1, 2009), http://nyr.kr/KpGeWM and Carrick Mollenkamp, Serena Ng, Liam Pleven and Randall Smith, *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, THE WALL STREET JOURNAL (Oct.31, 2008).

Between 2003 and 2007, Wall Street created $700 billion in CDOs that included mortgage-backed securities as collateral.[37] Wall Street managers were hungry for mortgages to fashion new CDOs, for which they profited handsomely. This appetite effectively enabled mortgage lenders to lower their underwriting standards because they believed they could easily unload newly issued mortgages to CDO underwriters. "In effect, the CDO became the engine that powered the mortgage supply chain," the FCIC wrote.[38]

But CDOs and credit default swaps were intertwined, as evidenced by the FCIC's finding that credit default swaps also "fueled the mortgage securitization pipeline."[39] Investors in CDOs gleaned a sense of security by purchasing credit default swaps, which, they believed, would protect them in case their CDOs failed. "Investors became unmoored from the essential risk underlying loans to non-credit worthy individuals" because credit default swaps provided a "seeming safety net to these risky investments," Greenberger wrote.[40]

The worldwide credit default swaps market, according to the FCIC, increased from $6.4 trillion at the end of 2004 to $58.2 trillion by the end of 2007.[41] As Greenberger has noted, that nearly equaled the gross domestic product for the entire world, which in 2007 was about $60 trillion.[42]

The danger posed by credit default swaps was compounded because—unlike most derivatives—they paid off their entire notional value if the underlying asset failed, rather than simply paying according to a fluctuation of an underlying asset value.[43] In a rough analogy, a traditional derivative would have paid the difference between a mortgage and the amount a bank could recoup in a foreclosure sale. But a CDS would pay the entire mortgage value. In practice, the stakes were astronomically greater due to the aggregated nature of the CDOs that credit default swaps insured.

[37] FCIC REPORT, at 129.
[38] *Id.*, at 128.
[39] *Id.*, at xxiv.
[40] DERIVATIVES IN THE CRISIS, at 12.
[41] FCIC REPORT, at 50.
[42] World Bank, http://bit.ly/w6l6pl.
[43] *The Role of Derivatives in the Financial Crisis Testimony, Financial Crisis Inquiry Commission* (June 30, 2010), testimony of Prof. Michael Greenberger, http://bit.ly/yiYNrt.

> "By 2008 our regulatory framework with respect to derivatives was manifestly inadequate."
> *—Former Treasury Secretary Lawrence Summers (2010)*

This danger was further exacerbated because multiple credit default swaps could be purchased on the same underlying asset. Besides using credit default swaps to insure assets they owned, investors could purchase them on assets owned by others. Such arrangements were called "naked credit default swaps" and were the equivalent of buying insurance on a neighbor's house in the hopes that it burns down.[44]

Naked credit default swaps marked an evolution in the purpose of derivatives from their traditional risk-management function to sheer gambling. When the financial crisis struck in 2008, three-to-four times as many naked credit default swaps were in circulation as credit default swaps held by investors who owned the underlying asset.[45] This amounted to many investors buying fire insurance on the same house. If one such house burned down, it would be a very bad day for the company insuring it. Naked credit default swaps left open the possibility that thousands or millions of houses that were insured many times over could, metaphorically, catch fire at once. Such a wildfire would constitute catastrophic day for the insurance company.

But issuers of credit default swaps—particularly AIG—saw no such risk. They viewed the fees they received from credit default swaps as virtually free money because they did not think they would ever have to pay. AIG's models showed only a 0.15 percent chance—1 in 667—that it would ever have to make a single payment on a credit default swap because of the supposed diversity of assets within CDOs.[46]

Because of this misplaced confidence and the absence of regulations to prevent firms from taking undue risks, credit default swap issuers did not maintain adequate reserves in case of disaster. AIG, for instance, took on $500 billion in credit default swap risks without being required to post any collateral, according to the FCIC.[47]

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[44] *See, e.g.*, MICAH HAUPTMAN, PUBLIC CITIZEN, BANKING ON FAILURE: SPECULATORS' USE OF CREDIT DEFAULT SWAPS TO BET ON OTHERS' MISFORTUNE IS UNSEEMLY, DANGEROUS (November 2011), http://bit.ly/xmcKHd.
[45] DERIVATIVES IN THE CRISIS, at 14.
[46] Brady Dennis and Robert O'Harrow Jr., *A Crack in The System*, WASHINGTON POST (Dec. 30, 2008), http://wapo.st/2qmzdG.
[47] FCIC REPORT, at 50.

> "Very strongly held views in the financial services industry in opposition to regulation were insurmountable."
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> *—Former Treasury Secretary Robert Rubin, claiming in 2010 that he had favored greater regulation of derivatives in the 1990s*

Issuers of credit default swaps were permitted to take such risks in part because credit default swaps were not regarded as insurance, even though that is essentially what they were.[48] If credit default swaps were defined as insurance, they would have been regulated by the states. This means they would have been subject to capital reserve requirements and naked credit default swaps would have been illegal.[49]

"Under state insurance law, [naked credit default swaps] would be considered insuring someone else's risk, which is flatly banned," Greenberger wrote. To preserve their non-insurance status, credit default swap dealers advised bond issuers who purchased their products to refer to them as "swaps," not insurance.[50]

The fact that credit default swaps were traded off of regulated exchanges heightened the risk they posed. On regulated exchanges, a clearing facility guaranteed each counterparty against the others. Consequently, the clearing facility required the parties to post adequate collateral. No such protections applied to over-the-counter trades.[51]

Eventually, the housing bubble burst, causing widespread mortgage defaults and corresponding defaults of CDOs. Holders of credit default swaps that insured those CDOs demanded billions of dollars in collateral. But AIG, the largest CDS provider, had nowhere near the capital to satisfy these demands. AIG's inability to make good on its obligations threatened to trigger a chain reaction of failures throughout the financial system that would cripple the economy. [52]

[48] MICAH HAUPTMAN, PUBLIC CITIZEN, BANKING ON FAILURE: SPECULATORS' USE OF CREDIT DEFAULT SWAPS TO BET ON OTHERS' MISFORTUNE IS UNSEEMLY, DANGEROUS (November 2011), http://bit.ly/xmcKHd.
[49] DERIVATIVES IN THE CRISIS, at 12.
[50] *Id.*, at 13.
[51] *Id.*
[52] *See, e.g.*, Mary Williams Walsh, *A.I.G. Secures $150 Billion Assistance Package*, THE NEW YORK TIMES (Nov. 10, 2008), http://nyti.ms/IJGNes.

> "Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief.."
> *—Former Federal Reserve Chairman Alan Greenspan (2008)*

This threat prompted Congress to authorize hundreds of billions of dollars in bailouts to prevent a full economic meltdown. AIG has since received at least $140 billion from the government through various programs.[53] To put this figure in perspective, it would fund the SEC for about 105 years and the CFTC for about 683 years.[54]

C. The Policy Makers Who Pushed for Derivatives Deregulation Now Admit They Were Wrong.

Today, there is widespread consensus, even among those who pressed for a laissez faire approach in the 1990s, that creating a regulation-free haven for derivatives was a big mistake.

In 1998, Lawrence Summers warned Brooksley Born that any step toward regulating derivatives would cause the greatest economic disaster since World War II. He also co-signed the report claiming that parties in derivatives trades did not need oversight because they were "sophisticated."

He no longer holds these views. While stating that he could not have foreseen the changes in the derivatives market when he pressed for deregulation, he told the FCIC that "by 2008 our regulatory framework with respect to derivatives was manifestly inadequate."[55]

Robert Rubin, Summers' predecessor as Treasury secretary, co-signed the 1998 statement expressing "grave concerns" about Born's solicitation of opinions on whether to alter derivatives' regulation. He now sees this episode differently. He had agreed with Born's views at the time, he told the FCIC in 2010, but "very strongly held views in the financial services industry in opposition to regulation were insurmountable."[56]

[53] *Id.* and *Where Is the Money: Eye on the Bailout*, PROPUBLICA, http://bit.ly/zIe07I.
[54] U.S. SECURITIES AND EXCHANGE COMMISSION IN BRIEF FY 2013 CONGRESSIONAL JUSTIFICATION (February 2012), http://1.usa.gov/AcnCZH and Christopher Doering, *Obama Seeks $308 Million Budget for CFTC*, REUTERS (FEB. 10, 2012), http://reut.rs/xYcMe7.
[55] FCIC REPORT, at 49..
[56] *Id.*

> "Even if less than 1 percent of the total investment community is involved in derivative exchanges, so much money was involved that if they went bad, they could affect 100 percent of the investments. And indeed 100 percent of the citizens ... and I was wrong about that."
>
> *—Former President Bill Clinton (2010)*

In Rubin's defense, he warned about the risks of unregulated derivatives in his 2003 memoirs.[57] But when critical decisions were being made in the late 1990s, Rubin used his substantial influence to help block regulation, not to insist on it.[58]

Former Federal Reserve Chairman Greenspan, who was perhaps the most ardent advocate for deregulating derivatives, admitted at the onset of the financial crisis in 2008 that he had been "partially" wrong in his view that derivatives did not require more oversight. "Credit default swaps, I think, have serious problems associated with them," he testified. More fundamentally, in repudiation of his longstanding faith in markets' ability to regulate themselves, Greenspan testified, "those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief."[59]

Greenspan continued: "The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations, undeniably the original source of the crisis, would have been far smaller and defaults, accordingly, far fewer"[60]

Former President Clinton expressed a mea culpa for allowing himself to be convinced that the regulation of derivatives was unnecessary because only sophisticated investors traded them. "Even if less than 1 percent of the total investment community is involved in derivative exchanges, so much money was involved that if they went bad, they could affect 100 percent of the investments, and indeed 100 percent of the citizens ... and I was wrong about that."[61]

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[57] Dan Froomkin, *Rubin: I Actually Supported Regulating Derivatives*, HUFFINGTON POST (June 20, 2010), http://huff.to/aMXj1N.
[58] *Id.*
[59] Testimony of former Federal Reserve Chairman Alan Greenspan before the House of Representatives Committee on Government Reform (110th Cong., Oct. 23, 2008), http://bit.ly/JcqBPL.
[60] *Id.*
[61] Dan Froomkin, *Rubin: I Actually Supported Regulating Derivatives*, HUFFINGTON POST (June 20, 2010) http://huff.to/aMXj1N.

D. Dodd-Frank Enacted Significant Reforms but Members of Congress Are Seeking to Reduce These Protections.

The Dodd-Frank law instituted measures to make derivatives trading transparent and less risky for the financial system. The law generally called for swaps to be traded on designated exchanges, to be cleared by designated organizations, and to be subject to capital and margin requirements.

Trading on exchanges provides for transparency, permitting buyers to shop for competitive prices. Clearing ensures that centralized organizations accept responsibility to make good on contract obligations. This would prevent reprisals of the AIG episode, in which no backstop was in place—save for the taxpayers. The capital and margin requirements plug the gaping regulatory hole that allowed the likes of AIG to take on risks that exceeded its resources. The act allowed swaps that are highly customized be traded off of exchanges. But even in these cases, it imposed capital and margin requirements and insisted on public reporting.[62]

Since the passage of Dodd-Frank, industry has engaged in a concerted effort to weaken it. At least nine bills are pending in Congress that would water down its derivatives reforms. Three additional bills would saddle federal agencies with additional burdens to fulfill requirements to issue concerning financial services, including those involving derivatives. [See Appendix]

Among other things, these bills would eliminate a requirement for federally insured banks to spin off their derivatives operations;[63] reduce disclosure requirements for certain derivatives trades;[64] provide a broad exemption from Dodd-Frank's provisions for swaps involving foreign affiliates of U.S. companies;[65] and exempt purportedly small players, even those with up to $200 billion in the notional value of their derivatives exposure.[66]

These proposals threaten to create large oversight-free zones that could allow risky behaviors to flourish. We have seen the damage caused by the errors in judgment in the late 1990s. Congress and federal agencies need to ensure that there is no sequel.

[62] Dodd-Frank Wall Street Reform and Consumer Protection Act § 701-814 and DERIVATIVES IN THE CRISIS, at 17-26.
[63] H.R. 1838, 112th Cong. (2011).
[64] H.R. 2586, 112th Cong. (2011).
[65] H.R. 3283, 112th Cong. (2011).
[66] H.R. 3336, 112th Cong. (2012) and Letter from Americans for Financial Reform to members of Congress (April 11, 2012).

Appendix

Bills Seeking to Weaken Derivatives Regulation

Bill Number, Title Sponsor	Brief Summary	Status
H.R. 1838, Swaps Bailout Prevention Act, Rep. Nan Hayworth (R-N.Y.)	Amends Section 716 of Dodd-Frank (known as the Lincoln amendment), which bans federally insured financial institutions from engaging in swaps trading. Amended in committee to exempt foreign swap activity by subsidiaries of U.S. banks.	Passed House Committee on Financial Services by voice vote, Feb 16, 2012.
H.R. 2586, Swap Executive Facility Clarification Act, Rep. Scott Garrett (R-N.J.)	Bans regulators from requiring swaps exchanges (SEFs) to make bids or offers available to participants.	Passed House Committee on Financial Services by voice vote, Nov. 30, 2011; Passed House Committee on Agriculture by voice vote, Jan. 25, 2012.
H.R. 2682, Business Risk Mitigation and Price Stabilization Act, Rep. Michael Grimm (R-N.Y.)	Prohibits regulators from requiring derivatives end users qualifying for clearing exemption (such as airlines) to post margin.	Passed House 370-24 on March 26, 2012. (Corresponds with Senate Bill S. 1650)
H.R. 2779, (no title), Rep. Steve Stivers (R-Ohio)	Provides broad exemption from regulation of swaps between affiliates.	Passed House 357-36, March 26, 2012.
H.R. 3283, Swap Jurisdiction Certainty Act, Rep. Jim Himes (D-Conn.)	Provides broad regulatory exemption for U.S. swap dealers when dealing with foreign entities, including foreign affiliates of U.S. companies; replaces U.S. capital regulation and oversight for foreign affiliates of U.S. companies with oversight by the non-U.S. jurisdiction.	Passed House Committee on Financial Services 41-18, March 27, 2012; referred to House Committee on Agriculture.
H.R. 3336, Small Business Credit Availability Act, Rep. Vicky Hartzler (R-Mo.)	Exempts any bank, thrift, credit union or farm credit institution from being considered a "financial entity" if it has less than $1 billion in "outward exposure" or swaps connected to hedges.	Passed House 312-111, April 25, 2012.
H.R. 3527, Protecting Main Street End-Users from Excessive Regulation, Rep.Randy Hultgren (R-Ill.)	Exempts transactions for hedging or mitigating commercial risk from the calculation of whether one meets the threshold to be designated as a swap dealer; creates exemption from margin and clearing requirements for swap dealers trading up to $3 billion in notional value annually.	Passed House Committee on Agriculture by voice vote, Jan. 25, 2012.
S. 947, (no title), Sen. Mike Johanns (R-Neb.)	Exempts various trades from specified margin requirements, including swaps in which one of the counterparties is neither a swap dealer nor a major swap participant.	Referred to Senate Committee on Banking, Housing, and Urban Affairs.
S. 1650, Dodd-Frank Improvement Act, Sen. Mike Crapo, (R-Idaho)	Establishes SEC Office of Derivatives to coordinate oversight and administer derivatives-related rules.	Referred to Senate Committee on Banking, Housing, and Urban Affairs.

Bills Imposing Addition Burdens for Agencies to Promulgate Financial Regulations

Bill Number, Title Sponsor	Brief Summary	Status
H.R. 1840, no title, Rep. Michael Conaway (R-Texas)	Requires detailed cost-benefit analysis of all CFTC regulations.	Passed by House Committee on Agriculture by voice vote, Jan. 25, 2012.
H.R. 2308, SEC Regulatory Accountability Act, Rep. Scott Garrett (R-N.J.)	Requires detailed cost-benefit analysis of all SEC regulations.	Approved by House Financial Services Committee 30-26, Feb. 16, 2012.
S. 1615, Financial Regulatory Responsibility Act of 2011, Sen. Richard Shelby (R-Ala.)	Prohibits issuance of regulations if quantified costs are greater than the quantified benefits; authorizes judicial review for a person adversely affected or aggrieved by a regulation; establishes the Chief Economists Council to report to certain congressional committees on activities of the financial regulatory agencies.	Referred to Senate Committee on Banking, Housing, and Urban Affairs.