



G A O

Accountability • Integrity • Reliability

United States Government Accountability Office
Washington, DC 20548

January 26, 2007

The Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
House of Representatives

Subject: Credit Derivatives Market and Information Technology

Dear Mr. Chairman:

This letter confirms our commitment to study the use of information technology in the credit derivatives market based on your letter to the Comptroller General. In our October 5, 2006, letter to you, we outlined our approach to designing the study. Based on that design and discussions with your staff and staff of the Committee's Ranking Member on December 14, 2006, we will complete our work and issue a report to you by June 27, 2007. Also as discussed during that meeting, we will provide periodic updates to your staff and the staff of the other requesters, and notify them of any difficulties we encounter in obtaining cooperation from the organizations we are reviewing. Please see enclosure I for the list of requesters with whom we will be coordinating. Enclosure II sets forth the key aspects of the study.

We look forward to working with you and your staff on this assignment. Should you have any questions, please contact me on (202) 512-2717 and jonesy@gao.gov or, Cody Goebel, Assistant Director, on (202) 512-7329 and goebelc@gao.gov.

Sincerely yours,

Yvonne D. Jones
Director, Financial Markets
and Community Investment

Enclosures - 2

cc: Brian McCullough
Consuela Washington

LIST OF REQUESTERS

The Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
House of Representatives
(Staff Member: Consuela Washington)

The Honorable Joe Barton
Ranking Member, Committee on Energy and Commerce
House of Representatives
(Staff Member: Brian McCullough)

The Honorable Edward J. Markey
Chairman, Subcommittee on Telecommunications and the Internet
Committee on Energy and Commerce
House of Representatives

The Honorable Fred Upton
Ranking Member, Subcommittee on Telecommunications and the Internet
Committee on Energy and Commerce
House of Representatives

The Honorable Bobby L. Rush
Chairman, Subcommittee on Commerce, Trade, and Consumer Protection
Committee on Energy and Commerce
House of Representatives

The Honorable Clifford B. Stearns
Ranking Member, Subcommittee on Commerce, Trade, and Consumer Protection
Committee on Energy and Commerce
House of Representatives

The Honorable Jan Schakowsky
Subcommittee on Commerce, Trade, and Consumer Protection
Committee on Energy and Commerce
House of Representatives

Terms of the Work

Objectives/Key Questions

The broad objectives of the study and their key questions are the following.

1. What are credit derivatives, and how are they traded and regulated?
 - Who uses credit derivatives, for what purposes, and how large is the market?
 - Who regulates the credit derivatives market, including its participants, and how?
2. How are credit derivatives dealers and other market participants, in conjunction with U.S. regulators, addressing operational and related issues resulting from the backlog of outstanding confirmations?
 - How do dealers process their credit derivatives transactions, and to what extent is the process automated?
 - What factors led to the significant backlog of outstanding confirmations at major dealers, and what risks did the backlog pose to dealers and the market?
 - How and when did U.S. regulators become aware of the backlog at the major dealers, and what role have they played in addressing its risks?
 - What actions are dealers and other market participants taking to reduce the confirmation backlog and confirm new trades in a timely manner?
3. How are dealers and other market participants, in conjunction with U.S. regulators, addressing other post-trade processing and related issues in the credit derivatives market?
 - Separate from confirming trades, what other operational or related challenges do dealers face in processing their credit derivatives trades over the life of the contracts?
 - How are dealers and other market participants, in conjunction with U.S. regulators, addressing such challenges?
4. How have U.S. regulators and dealers assessed the resiliency, reliability, and security of the information technology systems used by dealers to process their credit derivatives transactions?
 - Where does the firm process its credit derivatives trade information, and does it geographically disperse processing sites as a backup?

-
- How does the firm prevent unauthorized access to its credit derivatives trade information, including access controls and security audits?

Scope

For objective 1, the scope of our audit work will focus primarily on (1) studies and surveys on the credit derivatives market and (2) U.S. federal laws and regulations covering credit derivatives and participants in the market. Credit derivatives dealers, rather than the instruments themselves, are regulated. As the major U.S. dealers are national banks and securities firms, our audit work will primarily involve the Office of the Comptroller of the Currency (OCC) and Securities and Exchange Commission (SEC) and, to a lesser extent, the Federal Reserve System.

For objectives 2 and 3, the scope of our audit work will focus primarily on three groups: U.S. regulators, dealers, and industry organizations. In terms of regulators, our audit work will involve primarily the Federal Reserve System, OCC, and SEC. In terms of dealers, nine U.S. dealers and five foreign dealers are participating in the Federal Reserve Bank of New York's (FRBNY) initiative. We will interview six U.S. dealers and one foreign dealer and base our selection on factors such as their trading volume and size of their confirmation backlog. In terms of industry organizations, our audit work will involve primarily the Depository Trust and Clearing Corporation, which is playing a key role in automating trade processes; the International Swaps and Derivatives Association, which is playing a lead role in streamlining documentation for credit derivatives contracts; and the Bond Market Association and Managed Funds Association, which represent the major end-users of credit derivatives.

For objective 4, the scope of our audit work will focus primarily on OCC and SEC as well as our sample of six U.S. dealers.

Methodology

To address questions under objective 1, we will review and analyze private and public sector reports and surveys on the credit derivatives market, in part to document the market's structure, major participants, and notional size. We will also review and analyze U.S. federal laws and regulations pertaining to the regulation of credit derivatives and their users as well as interview Federal Reserve, OCC, and SEC staff about their oversight of credit derivatives dealers.

To address questions under objectives 2 and 3, we will interview regulators, dealers, and industry organizations about the causes of the confirmation backlog, steps taken to automate the confirmation process, and challenges remaining in the credit derivatives market. In addition, we will review and analyze SEC's examinations of the five U.S. securities firms

participating in the FRBNY initiative to document any findings related to credit derivatives. Similarly, we will review and analyze OCC's examinations and related materials (dating back to 2004) for the four national banks participating in the FRBNY initiative to document any findings related to credit derivatives. We also will review and analyze the Federal Reserve's examinations and related materials (dating back to 2004) covering the holding companies of the four national banks and one foreign bank operating in the United States. Finally, we will analyze dealer-provided data to document the extent to which the 14 major dealers have reduced outstanding confirmations and automated the confirmation process since the FRBNY initiative.

To address objective 4, we will interview dealers on their business continuity capabilities and information security practices for their credit derivative systems. We will also interview regulators and review examination reports to identify the extent to which regulators have reviewed these systems as part of their oversight.

We will conduct our work in accordance with Generally Accepted Government Auditing Standards. We will obtain comments from the Federal Reserve System, OCC, and SEC on a written draft of this product before issuance.

Product

Letter Report.

Product Delivery Date(s)

We will issue our product by June 27, 2007.

Reporting on Job Status

We will update your staff periodically as our work progresses.