Testimony Concerning Credit Default Swaps

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Chairman Peterson, Ranking Member Goodlatte, and Members of the House Committee on Agriculture:

I am pleased to have the opportunity today to again testify regarding the credit default swaps (CDS) market. My testimony today summarizes the key points from my testimony before this committee five weeks ago and updates it to reflect the Commission's activities since then.

CDS can serve important purposes. They can be employed to closely calibrate risk exposure to a credit or a sector. CDS can be especially useful for the business model of some financial institutions that results in the institution making heavily directional bets, and others — such as dealer banks — that take both long and short positions through their market-making and proprietary trading activities. Through CDS, market participants can shift credit risk from one party to another, and thus the CDS market may be an important element to a particular firm's willingness to participate in an issuer's securities offering.

The current CDS market operates solely on a bilateral, over-the-counter basis and has grown to many times the size of the market for the underlying credit instruments. In light of the problems involving AIG, Lehman, Fannie, Freddie, and others, attention has focused on the systemic risks posed by CDS. The ability of protection sellers (such as AIG and Lehman) to meet their CDS obligations has raised questions about the potentially destabilizing effects of the CDS market on other markets. Also, the deterioration of credit markets generally has increased the likelihood of CDS payouts, thus prompting protection buyers to seek additional margin from protection sellers. These margin calls have strained protection sellers' balance sheets and may be forcing asset sales that contribute to downward pressure on the cash securities markets.

In addition to the risks that CDS pose systemically to financial stability, CDS also present the risk of manipulation. Like all financial instruments, there is the risk that CDS are used for manipulative purposes, and there is a risk of fraud in the CDS market.

The SEC has a great interest in the CDS market because of its impact on the securities markets and the Commission's responsibility to maintain fair, orderly, and efficient securities markets. These markets are directly affected by CDS due to the interrelationship between the CDS market and the securities that compose the capital structure of the underlying issuers on which the protection is written. In addition, we have seen CDS spreads move in tandem with falling stock prices, a correlation that suggests that activities in the OTC CDS market may in fact be spilling over into the cash securities markets.

OTC market participants generally structure their acivities in CDS to comply with the CFMA's swap exclusion from the Securities Act and the Exchange Act. These CDS are "security-based swap agreements" under the CFMA, which means that the SEC currently has limited authority to enforce anti-fraud prohibitions under the federal securities laws, including prohibitions against insider trading. If CDS were standardized as a result of centralized clearing or exchange trading or other changes in the market, and no longer subject to individual negotiation, the "swap exclusion" from the securities laws under the CFMA would be unavailable.

Progress on Establishing a Central Counterparty for CDS

As announced on November 14th, a top priority for The President's Working Group on Financial Markets, in which the SEC Chairman is a member, is to oversee the implementation of central counterparty services for CDS. A central counterparty ("CCP") for CDS could be an important step in reducing the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts.

By clearing and settling CDS contracts submitted by participants in the CCP, the CCP could substitute itself as the purchaser to the CDS seller and the seller to the CDS buyer. This novation process by a CCP would mean that the two counterparties to a CDS would no longer be exposed to each others' credit risk. A single, well-managed, regulated CCP could vastly simplify the containment of the failure of a major market participant. In addition, the CCP could net positions in similar instruments, thereby reducing the risk of collateral flows.

Moreover, a CCP could further reduce risk through carefully regulated uniform margining and other robust risk controls over its exposures to its participants, including specific controls on market-wide concentrations that cannot be implemented effectively when counterparty risk management is uncoordinated. A CCP also could aid in preventing the failure of a single market participant from destabilizing other market participants and, ultimately, the broader financial system.

A CCP also could help ensure that eligible trades are cleared and settled in a timely manner, thereby reducing the operational risks associated with significant volumes of unconfirmed and failed trades. It may also help to reduce the negative effects of misinformation and rumors that can occur during high volume periods, for example when one market participant is rumored to "not be taking the name" or not trading with another market participant because of concerns about its financial condition and taking on incremental credit risk exposure to the counterparty. Finally, a CCP could be a source of records regarding CDS transactions, including the identity of each party that engaged in one or more CDS transactions. Of course, to the extent that participation in a CCP is voluntary, its value as a device to prevent and detect manipulation and other fraud and abuse in the CDS market may be limited.

The Commission staff, together with Federal Reserve and CFTC staff, has been evaluating proposals to establish CCPs for CDS. SEC staff has participated in on-site assessments of these CCP proposals, including review of their risk management systems. The SEC brings to this exercise its experience over more than 30 years of regulating the clearance and settlement of securities, including derivatives on securities. The Commission will use this expertise, and its regulatory and supervisory authorities over any CCPs for CDS that may be established, to strengthen the market infrastructure and protect investors.

To facilitate the speedy establishment of one or more CCPs for CDS and to encourage market participants to voluntarily submit their CDS trades to the CCP, Commission staff are preparing conditional exemptions from the requirements of the securities laws for Commission consideration. SEC staff have been discussing the potential scope and conditions of these draft exemptions with each prospective CCP and have been coordinating with relevant U.S. and foreign regulators.

In addition, last Friday, Chairman Cox, on behalf of the SEC, signed a Memorandum of Understanding (MOU) with the Federal Reserve Board and the Commodity Futures Trading Commission. This MOU establishes a framework for consultation and information sharing on issues related to CCPs for CDS. Cooperation and coordination under the MOU will enhance each agency's ability to effectively carry out its respective regulatory responsibilities, minimize the burden on CCPs, and reduce duplicative efforts.

Other Potential Improvements to OTC Derivatives Market

As explained above, the SEC has limited authority over the current OTC CDS market. The SEC, however, is statutorily prohibited under current law from promulgating any rules regarding CDS trading in the over-the-counter market. Thus, the tools necessary to oversee this market effectively and efficiently do not exist. Chairman Cox has urged Congress to repeal this swap exclusion, which specifically prohibits the SEC from regulating the OTC swaps market.

Recordkeeping and Reporting to the SEC

The repeal of this swap exclusion would allow the SEC to promulgate recordkeeping requirements and require reporting of CDS trades to the SEC. As I discussed in my earlier testimony, a mandatory system of recordkeeping and reporting of all CDS trades to the SEC, is essential to guarding against misinformation and fraud. The information that would result from such a system would not only reduce the potential for abuse of the market, but would aid the SEC in detection of fraud in the market quickly and efficiently.

Investigations of over-the-counter CDS transactions have been far more difficult and time-consuming than those involving cash equities and options. Because these markets lack a central clearing house and are not exchange traded, audit trail data is not readily available and must be reconstructed manually. The SEC has used its anti-fraud authority over security-based swaps, including the CDS market, to expand its investigation of possible market manipulation involving certain financial institutions. The expanded investigation required hedge fund managers and other persons with positions in CDS and other derivative instruments to disclose those positions to the Commission and provide certain other information under oath. This expanded investigation is ongoing and should help to reveal the extent to which the risks I have identified played a role in recent events. Depending on its results, this investigation may lead to more specific policy recommendations.

However, because of the lack of uniform recordkeeping and reporting to the SEC, the information on security-based CDS transactions gathered from market participants has been incomplete and inconsistent. Given the interdependency of financial institutions and financial products, it is crucial for our enforcement efforts that we have a mechanism for promptly obtaining CDS trading information — who traded, how much and when — that is complete and accurate.

Recent private sector efforts may help to alleviate some of these concerns. For example, Deriv/SERV, an unregulated subsidiary of DTCC, provides automated matching and confirmation services for over-the-counter derivatives trades, including CDS. Deriv/SERV's customers include dealers and buy-side firms from more than 30 countries. According to Deriv/SERV, more than 80% of credit derivatives traded globally are now confirmed through Deriv/SERV, up from 15% in 2004. Its customer base includes 25 global dealers and more than 1,100 buy-side firms in 31 countries. While programs like Deriv/SERV may aid the Commission's efforts, from an enforcement perspective, such voluntary programs would not be expected to take the place of mandatory recordkeeping and reporting requirements to the SEC.

In the future, Deriv/SERV and similar services may be a source of reliable information about most CDS transactions. However, participation in Deriv/SERV is elective at present, and the platform does not support some of the most complex credit derivatives products. Consequently, not all persons that engage in CDS transactions are members of Deriv/SERV or similar platforms. Greater information on CDS trades, maintained in consistent form, would be useful to financial supervisors. In addition to better recordkeeping by market participants, ready information on trades and positions of dealers also would aid the SEC in its enforcement of anti-fraud and anti-manipulation rules. Finally, because Deriv/SERV is unregulated, the SEC has no authority to obtain the information stored in this facility for supervision of risk associated with the OTC CDS market and can only obtain it if given voluntarily or by subpoena.

Market Transparency

Market transparency is another improvement to the CDS market that the Commission supports. The development of a CCP could facilitate greater market transparency, including the reporting of prices for CDS, trading volumes, and aggregate open interest. The availability of pricing information can improve the fairness, efficiency, and competitiveness of markets – all of which enhance investor protection and facilitate capital formation. The degree of transparency, of course, depends on participation in the CCP, which currently is not mandatory.

Exchange Trading

A CCP also could facilitate the exchange trading of CDS because the CDS would be in standardized form. Exchange trading of credit derivatives could add both pre- and post-trade transparency to the market that would enhance efficient pricing of credit derivatives. Exchange trading also could reduce liquidity risk by providing a centralized market that allows participants to efficiently initiate and close out positions at the best available prices.

Some of the prospective CCPs for CDS are proposing to offer some type of trading facility. In addition, we anticipate that other entities may develop trading platforms for CDS. The SEC believes it is important that the CCPs be open to clearing trades in eligible CDS from any participant that meets a fair and objective set of access criteria, including a participant that operates an exchange or other trading facility.

In crafting any regulatory solution, it is important to keep in mind the significant role CDS play in today's financial markets, as well as the truly global nature of the CDS market. Further, the varied nature of market participants in CDS and the breadth of this market underscore the importance of cooperation among U.S. financial regulators and supervisors at the federal and state level, as well as regulators and supervisors internationally.

Thank you for this opportunity to discuss these important issues. I am happy to take your questions.