

Remarks by Larry Thompson, General Counsel, The Depository Trust & Clearing Corporation Keynote Address - Derivatives Update: Impact of Dodd-Frank Financial Markets World conference June 9, 2011, New York, NY

Derivatives and Dodd-Frank: The Drive for Certainty and Clarity

Thank you, Margaret. Good morning, everyone. I want to thank Financial Markets World for inviting me to participate in today's forum. I had the honor to serve as a panel moderator at a forum they hosted earlier this year, and I'm delighted to be back to share my thoughts on the implementation of Dodd-Frank – a topic that has been top-of-mind for everyone in the financial services industry.

Since this landmark legislation was signed into law last July, it seems as if we've all been on a mad dash to prepare for the implementation of the bill – a dash that has included analyzing and responding to hundreds of proposed rules... participating in and attending dozens of regulatory roundtables...and reading a never-ending stream of news coverage.

In some ways, the lead-up to the implementation of Dodd-Frank reminds me of the current countdown to Derek Jeter's 3,000th hit. Think about it -- we all know it's going to happen, but we're not certain when. We know it'll have an impact on the game, but we're not sure how. We know it'll be hailed as a historic moment, but only time will be the true measure.

Seventh Inning Stretch

If I can continue the baseball analogy for a moment, it feels like we're in the seventh inning stretch right about now. A good deal—but not all—of Dodd-Frank's proposed rules have been made public. The agencies and the industry now have a brief moment to catch their breath and take a fresh look at them before heading into the final innings. While the law calls for the rules to be completed and implemented by July 16 – about five weeks from today – the reality is that we're headed into extra innings.

Behind that reality is a growing alarm about the impact the agencies' unfinished business will have on the industry. There's concern that a whole raft of provisions in Dodd-Frank will automatically take effect on July 16 without any guidance or language from either the SEC or the CFTC. For example, unless the regulatory agencies delay the implementation of the rules, whole categories of swaps will suddenly be treated as securities that require registration, the use of collateral and so on.

Earlier this week there were reports that, in order to avoid this confusion, the Securities Industry and Financial Markets Association, or SIFMA, is preparing to ask the SEC to delay implementation of all the Dodd-Frank derivative provisions that the agencies haven't yet finalized. Now, CFTC Commissioner Scott O'Malia is saying the agency plans to create some sort of moratorium until the underlying rules can be written.

That's welcome news. But, to stay with the baseball metaphor, we might experience a "delay of game," which has both good and bad aspects. The "good" is that regulators recognize the systemic impact the rules will have on the industry, and they understand the importance of getting it right rather than doing it fast. It also signals that regulators want to collect as much data and feedback as possible from market participants before finalizing the rules. As an industry, we should take advantage of this opportunity. First, we need to share our thoughts on and reactions to the rules, so that we can discuss ideas and identify areas of concern. Second, we must continue to stay in touch with the agencies, and to put our thoughts down on paper for the agencies as they re-open the public comment period.

As I mentioned, though, there's also a "bad" side and, in this case, it's the lack of clarity over when the rules will be finalized, what the rules will say and the timeframe for the industry to implement them. Taken together, this creates uncertainty in the marketplace. As today's conference reflects, this uncertainty is especially acute in the derivatives arena, where Dodd-Frank requires regulators to make major changes in the business practices the industry has developed over the course of decades.

Uncertainty, especially during times of market stress or during a post-recessionary period like the one we're in now, is not conducive to fostering the type of long-term economic growth that's essential to creating jobs. Financial markets, in particular, detest uncertainty. But that's what we face at the moment. In some cases, the market has already evolved in response to what it thinks the new regulations will require. In anticipation of the Volker Rule, for example, the country's major banks have begun to shed their proprietary investment vehicles and are instead putting their capital into much longer-term investments.

In fact, Citigroup announced last week that it was shuttering a \$400 million hedge fund that traded the firm's own money. What this tells us is that change is already happening in response to Dodd-Frank, even though the rules are not yet final. As you can imagine, this creates a whole series of new challenges that financial firms will face in the months and, possibly in some cases, the years ahead.

The Phase-in Timetable

Regulators, to their credit, generally understand the need to provide market participants with a greater degree of clarity on the timetable for implementing the new rules. Just last week, for instance, CFTC Chairman Gary Gensler noted that the Commission will miss the July 16 deadline for having all its new swaps rules written. He acknowledged that there are difficult legal issues if the new regulations don't get done soon. You have a panel scheduled later this morning that's going to talk about the sequence of rules and the timing of implementation, so I don't need to dwell on this.

I do, however, want to repeat what Mr. Gensler told us at DTCC when he was in New York some weeks ago and stopped by for a visit. He said he expected both the CFTC and the SEC to digest all the comments on the rules through part of summer and that he expects to have almost all the new rules down on paper by fall. From a planning perspective, he said, the industry should have a good idea what the final plan will look like by next spring, and could then begin making whatever adjustments are necessary so that full compliance on nearly all the rules could begin later next year. What this suggests is that it will be at least a full year, if not longer, from the time Congress mandated that the new rules be written until the rules actually begin to be put into effect.

The Road to Consensus

It's understandable that a period of uncertainty like this exists because regulators were tasked with making sweeping and dramatic changes to the rules that govern the financial markets. With an industry as globally diverse as financial services, and with so many different market participants, it's not surprising that the regulators themselves have their own differences of opinion on how issues should be addressed. Even we, as an industry, are finding it difficult to reach agreement on certain matters. The road to consensus has been long and full of detours, and it appears we still have a number of miles to travel before reaching the final destination.

In fact, consensus was the one element most obviously lacking during a recent Thought Leadership forum in Washington D.C. that DTCC hosted with the Managed Funds Association and Institutional Investors. There was certainly no shortage of opinions as buy-side firms, corporate end-users, senior staff at the U.S. regulatory agencies, Members of Congress and Congressional staff debated the impending changes to the swaps markets.

As I listened to the debate that day, it occurred to me that we're all trying to get at a fundamental question that, in all honesty, no one really knows the answer to just yet – and that is, whether a model based primarily on short-term instruments like financial futures can be applied to over-the-counter markets that, first off, are roughly ten times the size in terms of outstanding open interest, and secondly, include a significant proportion of longer-term instruments relating to thousands of different underlying assets and securities. Equally unclear but just as relevant is whether certain key provisions of Dodd-Frank, such as the use of swap executions facilities, central clearing and new real-time reporting requirements, will help accomplish the goals of reducing systemic risk and making markets more transparent, cost-effective and efficient.

Let's take a brief look at the new pre-trade and post-trade reporting rules as they relate to block trading. They're a good example of an issue in which regulators are struggling to find common ground. While there's widespread agreement that greater pricing transparency is necessary in the swaps market, there's also widespread concern that the rules, as currently drafted, could reduce liquidity, compromise price formation or result in a contraction of the bid/offer spread – all of which would harm the efficient operation of the market.

The CFTC wants quotes distributed to five counterparties—a position some observers suggest is overblown. The SEC thinks it can achieve transparency by dissemination of quotes to just one counterparty, which is an approach we support. There's also debate over collateral segregation and other technical points. These are the kinds of issues the regulators haven't sorted out yet, which is another reason SIFMA is asking for a moratorium on implementation.

The DTCC Role

At DTCC, we're intent on playing a role in trying to help the industry and regulatory community work through these types of issues. Over the past year or so, we've put a lot of time and effort into taking on a greater leadership role in the industry and positioning ourselves as a thought leader. We believe we have a lot to offer based on our nearly 40 years of experience as a clearinghouse for the U.S. equity and fixed income markets.....and because we have unique insight into the swaps market as the operator of the global repositories for credit default swaps and other derivatives.

While we run several clearinghouses, we don't clear OTC derivatives. We do, however, serve as the central swaps data repository – or SDR. We call this repository the Trade Information Warehouse, and we operate it out of both New York and London. We aggregate, distill and publish a good deal of the data we collect, with the result that we are able to provide an unprecedented degree of market transparency. We also give regulators from around the world direct electronic access to appropriate data to meet their own regulatory responsibilities. In other words, we're already achieving some of the transparency goals of Dodd-Frank in the CDS market.

Indemnification

Based on this experience, we're leveraging our knowledge to draw attention to certain rules that may be troublesome because of their potential for unintended consequences. One such issue is the indemnification provision tucked deep inside a section of Dodd-Frank intended to ensure the confidentiality and safety of data reported to and provided by swap data repositories. At issue is the requirement that US-based SDRs obtain indemnification agreements from foreign regulators prior to sharing critical market data with them.

The unintended consequence of this measure is that it will undermine the ability of regulators and market participants to obtain a comprehensive and unfragmented view of market data across the global marketplace. All of you here today understand just how global the swaps market is. If you can only see data from one or two jurisdictions, you can't possibly get a full picture of where the market is as a whole. And as a regulator, if you can't see the whole market, you can't see the potential for systemic risk.

Some Members of Congress have already begun outreach to their European counterparts to seek a resolution. We're working with them because we know, based on our experience operating the Trade Information Warehouse, how high the stakes are if the indemnification provision is enforced. However, the clock is ticking because the European Parliament is poised to adopt counter legislation in the final version of its own final reform regulation, which would mean that U.S. regulators, like the CFTC and SEC, could very likely face diminished access to information held in overseas repositories – just like their overseas counterparts. If a resolution can't be achieved between the U.S. and Europe, data sharing between global regulators will falter, creating precisely the type of barriers that Dodd-Frank sought to eliminate.

The Global Debate

The need for global harmonization of regulations cannot be overstated. Since the devastating global financial collapse three years ago, European leaders are not inclined to put too much faith in U.S. institutions or regulatory policy. They are intent on charting their own course on financial reform and not simply following the lead of the U.S.

Just last week, Michel Barnier, the European Union's financial markets commissioner, was in Washington to talk about this matter. He said he wants to make sure Brussels and Washington are acting (quote) "in parallel," but he threw the European equivalent of a knuckle ball when he made clear he doesn't think that's happening yet. While raising concern over the potential for international regulatory arbitrage, he also made it clear that if there isn't sufficient convergence, he will push for reciprocal agreements. And as I just mentioned, we've already seen that language on this issue of indemnification.

Last Monday, as many of you may know, U.S. Treasury Secretary Tim Geithner responded to Commissioner Barnier's talk. While reiterating a call for global derivative contract standards, Geithner suggested that the UK's regulatory regime had maintained a "light touch," and he predicted that without strong leadership there could be a global "race to the bottom"—his words, not mine. Secretary Geithner added that he would ask the Financial Stability Board, which is a global standard-setting group, to review various proposals and come up with recommendations.

Yesterday, Martin Wheatley, who has been Hong Kong's chief financial regulator for the last six years, replied to Secretary Geithner's remarks by saying (quote) "To suggest that the US sets the gold standard that other markets should follow is nonsense."

Market Evolution under Dodd-Frank

Obviously, we have some very different opinions coming from the US, Europe and Asia, and the reality is that the reform process is extremely fluid at the moment. I don't think there's a person in this room today, myself included, who can tell you what kind of structures regulators on both sides of the Atlantic or the Pacific will be looking at six months.....one year.....or even two years from now.

For example, not so long ago Fed Chairman Ben Bernanke spoke at a conference in Atlanta on clearinghouses and financial stability. He noted that centralizing clearing and settlement activities in clearinghouses means the concentration of (quote) "substantial financial and operational risk in a small number of organizations," a development, he said, with potentially important systemic implications. If you translate that from "Fedspeak," what it means is that the Fed is actually uneasy about piling so much risk, especially derivative product risk, onto clearinghouses, even if that's the direction Dodd-Frank and new European regulation take.

In this context, then, it might be good to ask ourselves what kind of market we expect to see.

- Will we end up with clearinghouses that assume so much risk in a growing market that they themselves become too big to fail? Is this Bernanke's nightmare?
- Will our regulatory structure risk draining much of the savings and efficiency that technology can bring to the market by artificially rationing which transactions must be handled by swap facilities, which ones go to clearinghouses, and which ones can simply undergo execution without any formal underlying infrastructure? This is the nightmare of chief technology officers. The more cost savings they generate, the more capital firms have to put into clearinghouses to meet their collateral requirements.
- Will we end up somewhat isolated in this country from a huge global business by having to meet regulatory requirements that are not in line with worldwide practices? This seems to be what Barnier was hinting at in his visit to Washington, and what Geithner wants to avoid.
- Or, since these are all unpleasant outcomes, will we find that our regulators are able to come to agreement and create a new structure that grows organically and sensibly, and in fact helps stabilize the derivatives business and encourages growth?

Market Competitiveness

As I look ahead to the next several months, I have two concerns.

One is that if we don't get our regulators to sit at a single table and find common ground, the regulatory rulemaking process will grind on separately, and the result for the global securities market will be sausage, and not very tasty sausage at that. Once each region gets locked into its idea of what the rules should be, trying to find common ground gets harder and harder.

While these are complex issues that will take time to be sorted out, there's another fundamental issue at play here -- how do we establish new rules and frameworks to address the vulnerabilities in the regulatory system that led to the financial crisis without creating a new regulatory regime that's so burdensome that it weakens the competitiveness of the U.S. marketplace?

The industry and regulators need to work together to find the right balance. The new rules can't be so severe that, while they make our markets safer, they also make them so restrictive that the lifeblood of the industry -- innovation, ingenuity and creativity -- are all but choked off. We know that capital will flow to the most competitive markets -- the ones that are efficient, liquid and robust. But we also know that the hallmark of such markets is a strong regulatory regime that promotes safety, soundness and stability. This is not an easy task by any means, and I know that regulators understand that critical issues like long-term economic growth, job creation and economic security will be impacted by the decisions they make in the weeks and months ahead.

The panelists participating in today's forum are certain to delve into these and other issues in greater detail throughout the day. As for myself, I'd like to hear your own thoughts on these topics. I'm more than happy to answer any questions you may have, or expand on any of the points I've raised. If not, thank you for listening to me this morning and for allowing me to share my thoughts on financial reform.