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Financial Markets Law Committee
“Derivatives Market Regulation: A View from the United States”
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Good afternoon. I want to thank the Financial Markets Law Committee for inviting me to participate in today’s conference. I’m delighted to be a part of this informative and interesting exchange of ideas today.

I’ve been asked to discuss the state of derivatives market regulation in the United States. It’s a topic that just about everyone is talking about these days. When I was in London a couple of months ago, I appeared on CNBC Squawk Box Europe to discuss Dodd-Frank and EMIR. After recording the segment, I heard from many folks across Europe who wanted to offer their own thoughts on the topics of trade repositories and global harmonization of regulations. After working a lot of years at DTCC, I never would have imagined that post-trade issues would suddenly become news.

While many of you may be familiar with DTCC, let me take a moment to tell the others a little more about our organization. DTCC provides global clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and data services for the derivatives market. We operate the central trade repository and central life-cycle event processing facility for the global credit derivatives market, which we call the Trade Information Warehouse, or TIW. I’ll talk more about the TIW and the role of trade repositories in the new financial landscape in just a few minutes.

To put size and dimension around DTCC’s global operations, we settled nearly US\$1.66 quadrillion dollars in securities transactions last year. For those who are curious, a quadrillion is a “one” followed by 15 “zeros.”

Dodd-Frank in Detail

Because we play a critical role in protecting the stability and integrity of global financial markets, DTCC has been actively engaged in the debate on financial reform in the U.S, Europe and Asia.

As a starting point for today’s discussion, it’s important to understand how sweeping Dodd-Frank is. The legislation covers 2,300 pages, calls for at least 243 separate rulemakings and establishes new rules for virtually every sector of the financial industry. However, despite the far-reaching scope of the law, Dodd-Frank is built on two fairly simple concepts:

- that the rules governing the futures market can be applied to the over-the-counter (OTC) derivatives market, and
- that the use of trading platforms and clearinghouses will reduce systemic risk and make these markets more transparent.

The question we in the industry are forced to answer is whether a model based primarily on short-term instruments like futures can be applied to the OTC swaps markets? As you know, the OTC swaps markets are roughly ten times the size in terms of outstanding open interest of the futures market and include a significant proportion of longer-term instruments relating to thousands of different underlying assets and securities. Until Dodd Frank is fully implemented, the answer is that we simply don’t know.

Trade Repositories Enhance Transparency

Regulators in the U.S. are still laboring over the new rules, and while they've made progress, they were unable to complete their work by last July – the deadline originally set by the U.S. Congress. It appears that the new deadline of December 2011 will not be met either.

The CFTC did approve final rules recently establishing the registration requirements and core principles for swap data repositories. As I mentioned earlier, DTCC operates the global repository for credit default swaps (CDS), so we had a great deal of interest in these rules and regulations.

Trade repositories are, in fact, an essential part of Dodd-Frank. Along with swap execution facilities and clearinghouses, they form the three pillars of the Dodd-Frank infrastructure. Repositories are the key to bringing transparency to the swaps derivatives markets because they will hold the underlying transaction data on all swaps derivatives trades. When this data is consolidated in a central repository, such as our TIW, market positions and concentration of risk are fully transparent to regulators worldwide. Thanks to our TIW, the CDS market is the most transparent in the world as far as regulatory understanding of counterparty exposures goes. In fact, the CDS market is even more transparent than the equity and bond markets.

A key feature of the TIW's transparency is the online regulators portal we created. The portal gives global supervisors unfettered, direct electronic access to detailed transaction data on virtually all CDS trades executed worldwide in which they have a material interest. Today, nearly 40 global regulators are actively using this portal to monitor systemic risk within their jurisdictions.

If, for instance, a British regulator wants to know the exposure of a particular British bank to the sovereign debt of Greece in the CDS market, it can obtain that information in a matter of seconds through the TIW. In fact, the regulator can access this data faster than it can obtain details about the actual debt holdings of that bank.

Indemnification Provision Undermines Transparency

That's the good news. The bad news, however, is that certain provisions in Dodd-Frank may create unintended consequences that will undo the progress that's been made in bringing transparency to this market.

The first provision is the indemnification clause in the data security section of Dodd-Frank (Sections 728 and 763), which was intended to ensure the confidentiality and safety of data. We'll file this under the heading "Good Intentions, Bad Results."

The requirement states that U.S.-based repositories must obtain indemnification from foreign regulators before sharing critical market data with them. The fact is that the regulators we've met with have told us that they are unlikely to enter into these agreements for two reasons. First, the extraterritorial mandate is inconsistent with traditions and legal structures in Europe. Second, global regulators are already following policies and procedures to safeguard and share data based on guidelines established by the OTC Derivatives Regulators Forum (ODRF).

Without an indemnity agreement, U.S.-based repositories may be legally precluded from providing critical market data to global regulators. The clear risk is that it may prompt these regulators to create their own local repositories to avoid indemnification – a move that could inevitably lead to data fragmentation. A proliferation of local repositories would make it extremely difficult to quickly and accurately obtain a full picture of any particular asset class. This is problematic because it would impair market and regulatory oversight, create inconsistencies in market data and impede data analysis.

The U.S. Commodity Futures Trading Commission (CFTC) tried to address the problems of indemnification in its final SDR rule, but the legal language in Dodd-Frank leaves little room for the regulators to act without U.S. Congressional intervention.

Fortunately, some Members of the U.S. Congress have reached out to their European counterparts to seek a resolution. But the clock is ticking. It's uncertain how the EU will respond. Either it can enact a pragmatic policy with which the U.S. and other nations could harmonize their regulations or it could follow the Dodd-Frank example by adopting a similar indemnification provision, which would open the door to regulatory arbitrage and fragmentation.

In our opinion, the latter would be a mistake. We believe Europe should provide international leadership on this issue and push for a uniform global data set.

Bundling of Services – Picking Winners

Now let me turn to the second issue that has raised concern for DTCC and other market participants. It involves new regulations that could potentially favor some service providers over others – what we call “picking winners.” Dodd-Frank is clear in its support for free market competition between trading platforms, clearinghouses and trade repositories. At DTCC, we strongly support the principle of competition among the three pillars of the Dodd-Frank infrastructure. The corollary to this is that we oppose both the horizontal and vertical bundling of services. In our view, service providers should compete on a level playing field.

However, the final rule for repositories approved by the CFTC in August seems to get it only half right. The rule prohibits horizontal bundling but seems to leave the door open for vertical bundling. In other words, under the rules a repository would not be permitted to tie its trade reporting services with non-mandatory ancillary services, such as asset servicing and confirmation. But a derivatives clearinghouse or execution platform may be able to require counterparties to report to a particular repository.

By permitting the bundling of mandated services, the CFTC would not only be picking winners – it would be permanently enshrining data fragmentation into the new regulatory landscape. And as I mentioned earlier when discussing indemnification, data fragmentation would undermine market safety and soundness and lead to the inaccurate public reporting of overall market data. We are working closely with the regulators to address this issue, but like indemnification, it's impossible right now to predict the outcome or impact on the market.

Global Harmonization

As you can see, for all the progress that's been made in the U.S. on financial reform, there's still a great deal of uncertainty in the market. And the level of uncertainty only increases when you consider that new regulations need to be harmonized globally.

The challenge going forward will be two-fold. First, we need to ensure that new U.S. regulations, which in some cases differ materially, are harmonized between the U.S. agencies. Just last week, for instance, the U.S. Government Accountability Office issued a report recommending that the U.S. regulatory agencies develop formal policies to guide the implementation of Dodd-Frank. It said that while the current ad-hoc approach could work, the process could breakdown over disagreements on policy. Second, we need to ensure the harmonization of global regulations between the U.S., Europe and Asia. As lawmakers look to resolve these issues, they'll also need to address differences of opinion over extra-territoriality, a hot-button issue that has the potential to derail harmonization efforts. I don't think we're at that point yet, but I know from my time here that there is genuine concern over the reach of Dodd-Frank to non-U.S. market participants.

Gaining consensus among dozens of supervisors across several continents will not be easy. Fortunately, events like today's conference are an important part of the dialogue, and I applaud the Financial Markets Law Committee for sponsoring this program. I know there's a full agenda, so I'll conclude my remarks now but will be happy to answer questions you may have during the Q&A session later today.

Thank you for listening and for allowing me to share my thoughts on financial reform.