Opening Statement of Chairman Timothy G. Massad, Open Meeting on Proposed Rule on Margin Requirements for Uncleared Swaps and Final Rule on Utility Special Entities

September 17, 2014

Good afternoon. This meeting will come to order.

This is a public meeting of the Commodity Futures Trading Commission (CFTC). It is the first open meeting of the Commission since two of my fellow Commissioners, Commissioner Bowen and Commissioner Giancarlo, and I took office. I am very pleased to have the benefit of their experience and insight as we move ahead. I also want to acknowledge and thank Commissioner Wetjen, our veteran, who has put in a tremendous effort, particularly over the first several months of this year when he served as Acting Chairman and who has been very helpful to all of us as we got up to speed on various issues. Thank you, Mark. And, I would like to welcome members of the public, market participants, and members of the media, as well as those listening to the meeting on the phone or watching the webcast.

As we take up any rule required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, we must never forget why the Act was passed and the motivations behind Title VII. The Dodd-Frank Act was a comprehensive response to the worst financial crisis since the Great Depression. While there were many causes of that crisis, one was excessive risk from the over the counter swaps market, a large, global industry essentially unregulated by any jurisdiction at that time. It was six years ago—September 16, 2008—when our government was required to step in and prevent the failure of AIG, which was on the brink of collapse because of excessive swap risk, a collapse that could have thrown our nation into another Great Depression.

These rules, like many of the Commission, are highly technical and complex, and they may seem esoteric and far removed from the lives of most Americans. But the costs of the crisis were not. They were very real, very large, and borne by the American people through millions of lost homes and jobs, many businesses shuttered, and many educations and retirements deferred. That is why these reforms are so important. And that is what brings us here today.

Today, we will consider a final rule that will help make sure that many of the small utility companies that serve communities across our nation can reduce their risk of doing business when it comes to the cost of fuel. We will also consider a proposed rule that will reduce the risk to our financial system that can be created when swap dealers enter into swaps that are not then cleared on central clearinghouses Both of these agenda items are important steps in our effort to finish the job of implementing the Dodd-Frank Act. They help us achieve the full benefit of the new regulatory framework, while at the same time protecting the interests of commercial companies that need to use these markets.

We will begin with consideration of the final rule pertaining to the swap activities of small utility companies--a small, but important, part of the market. This is what I like to

refer to as the fine tuning of rules that is inevitably required when you have reforms as significant as Dodd-Frank required.

Congress directed the Commission to regulate swap dealers. Among other things, we require swap dealers to treat customers fairly and manage risk adequately. Congress directed the Commission to impose heightened standards on swap dealers in their swaps activity with Federal, state and municipal government agencies and certain other so-called special entities. This was in response to the instances where swap dealers may have failed to disclose material risks of swap transactions to municipal entities or otherwise acted improperly, which often resulted in massive losses to the municipality.

Because Congress defined "special entity" broadly, when the Commission implemented this Congressional directive, it applied to many utility companies that are government owned. These are the companies responsible for keeping the lights on in communities across our country, for heating and cooling our homes, and powering the kitchen appliances we use every day to feed our families. To do their job, they must manage the risk of their own fuel costs, and to do that, they must be able to access the energy commodity markets. They engage in energy swaps. The counterparties with whom they transact business were often not registered swap dealers, nor were they the dealers that engaged in the abusive practices that led to Congress's concerns. The imposition of these requirements through a designation as a swap dealer could unduly burden their business and thereby threaten the ability of our local utility companies to manage their risks.

To avoid burdening local utility companies, CFTC staff issued a series of no-action letters, so that such requirements weren't effective while the Commission studied the issue further and decided whether to take permanent action.

The rule we are considering today provides a permanent solution to enable such utility companies to continue to use these markets effectively.

We are also considering today a proposed rule on margin requirements for uncleared swaps. A key mandate of the Dodd-Frank Act was central clearing of swaps. This is a significant tool to monitor and mitigate risk, and we have already succeeded in increasing the overall percentage of the market that is cleared from an estimated 17% in 2007 to 60% last month, when measured by notional amount.

But cleared swaps are only part of the market. Uncleared, bilateral swap transactions will continue to be an important part of the derivatives market. This is so for a variety of reasons. Sometimes, commercial risks cannot be hedged sufficiently through clearable swap contracts. Therefore market participants must craft more tailored contracts that cannot be cleared. In addition, certain products may lack sufficient liquidity to be centrally risk managed and cleared. This may be true even for products that have been in existence for some time. And there will and always should be innovation in the market, which will lead to new products.

That is why margin for uncleared swaps is important. It is a means to mitigate the risk of default and therefore the potential risk to the financial system as a whole. We need only recall how Treasury and the Federal Reserve had to commit $182 billion to AIG because their uncleared swaps activity threatened to bring down our financial system to appreciate the importance of the rule we are considering today.

The proposed rule requires swap dealers and major swap participants to post and collect margin in their swaps with one another. They must also do so in their swaps with financial entities if the level of activity is above certain thresholds. This focus on swap dealers and major swap participants is appropriate; they are the participants that much of our oversight is focused on. The proposal does not require commercial end-users to post or collect margin. This is an important point.

The two rules we are considering today thus share an important characteristic, which reflects one of my priorities, and I believe a priority of my fellow Commissioners: To make sure the overall regulatory scheme we are putting in place recognizes the needs and concerns of commercial end-users. While each rule is part of our framework for regulating the potential risks of this market, each proposal is designed to minimize burdens on commercial end-users who depend on the derivatives markets to hedge normal business risks.

Today's proposal on margin also reflects the benefit of substantial collaboration between our staff and our colleagues at the Federal Reserve, the OCC and the FDIC as well as significant public comment. The Dodd-Frank Act directs each of the prudential regulators to propose rules on margin for the entities for which it is the primary regulator. The CFTC is directed to propose a rule for other entities engaging in uncleared swaps transactions. The Dodd Frank Act also directed us to harmonize our rules as much as possible. Today's proposed rule is very similar to the proposal of the prudential regulators that was issued two weeks ago. I want to again thank our staff, as well as the staffs of the prudential regulators, for working together so well to accomplish that task.

We have also sought to harmonize our proposal with rules being developed in Europe and Asia. Our proposed rule is largely consistent with the standards proposed by Basel Committee on Banking Supervision and the International Organization of Securities Commissions, and we have been in touch with overseas regulators as we developed our proposal. There are a few differences that the staff will discuss.

The importance of international harmonization cannot be understated. It is particularly important to reach harmonization in the area of margin for uncleared swaps, because this is a new requirement and we do not want to create the potential for regulatory arbitrage in the market by creating unnecessary differences. Margin for uncleared swaps goes hand in hand with the global mandates to clear swaps. Imposing margin on uncleared swaps will level the playing field between cleared and uncleared swaps and remove any incentive not to clear swaps that can be cleared.

With regard to clearing, there has been attention lately on the issue of cross-border recognition of clearinghouses, so let me say a few words about that. I am firmly committed to working with the European Commission (EC) on this issue. In particular, it is very important that they recognize our exchanges and clearinghouses, to prevent any potential for market disruption, and so that European market participants can continue to trade and clear transactions in the United States. I believe we can and will achieve this soon.

A little history may be helpful. The Path Forward Statement issued in July 2013, by my predecessor as Chairman, Gary Gensler, and EC Vice-President Michel Barnier recognized the important role played by clearing organizations that are "registered in both the US and the EU." The Path Forward stated that the goal of avoiding "significant market fragmentation and uncertainty around clearing obligations" was to be achieved through the "EC's equivalence decisions and ESMA's recognition of foreign CCPs" along with the CFTC's issuance of "targeted no-action relief" to certain CCPs located in the European Union (EU). The CFTC provided such relief to two European CCPs at the same time the Path Forward was issued. And we are working now to finalize the remaining steps necessary to "provide an effective equivalent system for the recognition" of swap clearinghouses in Europe. This is the final remaining legal requirement for their recognition of our clearinghouses under our dual registration structure.

I believe our laws already permit the recognition of clearing houses on both sides of the Atlantic. It is important to understand how our clearinghouse recognition law works and how it is different than theirs. Our laws for the clearing of swaps were built on the laws and successful practices that have developed concerning the clearing of futures. We don't require that clearing of swaps take place in the U.S., just as we do not require that for futures traded on US exchanges. But Dodd-Frank does require that clearing of swaps for customers take place through a registered futures commission merchant or FCM, who in turn clears on a registered clearinghouse.

The law contains that requirement because clearing through an FCM and on a registered clearinghouse is very important for protecting U.S. customers. The requirements are closely tied to how U.S. bankruptcy law applies to an FCM. The standards ensure not only that customer funds are protected, but also that, in the event of a defaulting FCM, customer accounts can be moved quickly to another FCM. This is very important for stability, and we have seen its value, most recently in the crisis as well as in the failure of MF Global.

And this legal framework has worked to promote the global market. There have been clearinghouses located outside the US that have been registered with the US and with their home authorities for many years. We work with the home authority to insure cooperative supervision and oversight. The dually registered clearinghouses in Europe have grown to be globally important clearinghouses. One, for example, has been dually registered since 2001, and it handles most of the market for swap clearing, and a majority of that clearing is for US persons.

I also believe this is a good approach because central clearinghouses are even more important in the global financial system today as a result of our reforms to the OTC swap market. And therefore regulators must work together to make sure clearinghouses operate transparently and do not pose risks to financial stability. We have cooperated well with other regulators on this to date. I envision that cooperation and interaction increasing, not decreasing. Here at home, we are now working with the Federal Reserve on clearinghouse examinations, and we also are increasingly working with foreign regulators on the supervision of our clearinghouses.

In short, I believe the system of dual registration is not a source of potential market fragmentation; it is just the opposite—the foundation that allowed us to not insist that clearing take place on our shores, which has in turn led to a global market. And cooperative oversight is a key part of that.

But we must make sure that dual registration does not create conflicts and inconsistencies. And so that is what we are discussing currently. That is, the issue today is not primarily about the standards that apply to our clearinghouses. Our clearinghouses have long met the standards agreed to by international regulators, known as the Principles for Financial Market Infrastructures. Shortly after I took office, I traveled to Europe to meet with European regulators. They informed me that they were satisfied with our standards and did not have further issues. Our discussion today is focused on the EMIR requirement for "effective recognition" within this context of dual registration.

So we are looking at whether particular regulatory objectives that we have can be met through the regulation and oversight of the home country regulator. We are also exploring ways to enhance cooperation in the joint supervision of dually registered clearinghouses. I am hopeful we can reach agreement soon.

I am also encouraged by the recent statements from European Vice President Barnier and reports in the press that the European Commission can postpone the December 15 deadline for the imposition of capital charges on European firms for transactions on our exchanges and clearinghouses if recognition has not occurred by this time. While I believe we and they are still committed to resolving this well before such date, I think this is a very important gesture of good faith on their part, so that there is not a risk of market disruption.