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on the Harmonization of Market Regulation

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Chairman Shapiro, Chairman Gensler, and Commissioners, it is a pleasure to have the opportunity to address you today and submit testimony on the topic of regulatory harmonization and reform. I have had the privilege of serving with many of you here today, and my respect and regard for you and the important work you are doing cannot be overstated. The goal of regulatory harmonization is a desire that has been known to us all, and President Obama's push for the two Commissions to roll up their sleeves and actually come to terms with institutional and statutory differences and their competing interests and constituencies is most welcome.

I am Sharon Brown-Hruska, and I am a Vice President in the Securities and Finance Practice of NERA Economic Consulting. I served as a Commissioner at the CFTC from 2002-2006, and as Acting Chair in 2004 to mid 2005. I have also been a professor of finance and have taught courses on investments, derivatives, and risk management, and have focused my research on these areas. In the interest of efficiency, some of the substance of my remarks today comes from articles I have written, which I will gladly provide to you. At NERA, we are committed to quality and independence in our economic thinking and analysis. That said, I want to make clear that the views I express here today are my own, and do not necessarily reflect those of NERA or its staff.

We find ourselves at a pivotal point in defining the shape and scope of derivatives regulation. In the aftermath of a numbing liquidity and credit crisis, prudence dictates that we examine the causes of that crisis and the regulatory gaps and deficiencies that may have prevented it. Many of us in business, academia, and the public sector have taken that initiative, and our study and analysis of the crisis reveal some fundamental conclusions that are relevant to the SEC and CFTC efforts to streamline and harmonize regulation of the securities and derivatives markets. Our cause is to advance regulatory efficiency and ensure that systemic risks do not threaten our economy as they have in this crisis.

The impact of the real estate bubble began and reverberated from Main Street to Wall Street. The root cause of the crisis in the markets was not derivatives or securitized products themselves, but rather a shift in the risk factors underlying debt and credit that was not anticipated by either borrowers or lenders. The failure of firms and regulators to fully assess "tail risk" exposure in major dealers created weakness that spilled into many over-the-counter ("OTC") markets and reduced liquidity. This caused OTC market prices and collateral values to fall, and made lenders unable or unwilling to extend credit at previous levels. In short, the commonly held conclusion that Wall Street banks caused the crisis by trading in complex, unregulated derivatives is an oversimplification of the problems and not born out by the evidence.

The reason I raise this to you is that you are now looked to as the stewards of an important marketplace -- a market that exists so that the very risks that became stark and scary in the credit crisis can be assessed and managed. It is my view that addressing credit and systemic risk concerns by the wholesale restructuring of the OTC derivatives markets and by altering their well-developed mechanisms for contracting and risk mitigation goes beyond what is required to address these concerns and would impose unwarranted costs upon legitimate market users and intermediaries.

The direct and indirect costs of imposing a market structure based on the securities, or even the futures, regulatory models onto OTC markets are high. It is perhaps understandable that no one seems interested in talking about the costs, since we are fresh from an economic experience that most of us would like to avoid again *at all costs*. But we are going to have to look closely at the proposals to determine what actions are necessary to address actual market failures and control systemic risk. While the concept of a cost-benefit assessment may seem cliché, it is even more important to do so in a weak economy where hidden costs are seldom sunk, but more often passed along, and the negative consequences can seep into our financial fabric, dampen our collective recovery, and have both short and long-term effects on economic activity.

I will focus my testimony on a few areas in which I believe the costs of taking one approach or another need to be considered. I raise for you the precedent of the private capital markets, and how this construct, which is embedded in the Securities Exchange Act, the Investment Advisors Act of 1940, and the Commodity Exchange Act, enables businesses to access capital and efficiently shift risks to investors willing to bear it. In my view, the securities laws designed for exchange-traded assets have economic disincentives that have contributed to the issuance of equity in foreign venues, the creation of alternative "look-alike" products, and the growth of foreign domiciled investment vehicles. Those disincentives lead me to conclude that if certain mandates are applied to the OTC derivatives markets, including plans to force entities to use standardized products and the imposition of bans and *ad hoc* limits on positions, the costs to businesses of hedging will increase, the markets will contract, and this will adversely impact U.S. competitiveness.

Efforts to intelligently regulate significant players, under a principles-based regime with enhanced information (and perhaps more staff) should be the goals for regulatory harmonization. Increased transparency of financial positions to regulators should be a priority so that they are fully apprised of the risks undertaken by systemically important institutions. But we should use caution in rewiring risk systems and imposing constraints on the very products firms use to assess and transfer risks. In addition, regulatory harmonization should opt for regulatory structures that tend to encourage innovation and competition.

The Market for Private Capital and Contracts

The securities and futures laws are premised on the recognition of a well defined distinction between the public and private markets for capital and bilateral contracting. Thus, the current securities laws enable private placements, and as a result of a number of exemptions, the market for private equity and investment funds has resulted in the funding of innovative companies, young businesses, distressed companies, and other entities seeking financing. The U.S. private capital market is the envy of the world for its encouragement of entrepreneurship and innovation. Congress and the SEC have not previously sought to impose direct regulation because of the importance of the private market for capital formation to the U.S. economy. The private model succeeds because its participants are limited to sophisticated investors, including institutional and high net worth investors, who are apprised of the risks of investing through vigorous due diligence and accountability, which avoids the creation of a moral hazard for the government.

The over-the-counter derivatives market is a private, bilateral contracting market for transactions between large, commercial counterparties whose business activity and future plans form the basis for their decisions and dictate the types of contracts they demand. In the current regulatory framework, as privately negotiated contracts, OTC derivatives are governed by the commercial laws that would apply to any private contract. While they are exempted or excluded from some provisions of the securities and futures laws, the SEC and the CFTC have been given enforcement authority to exercise and enforce their Federal anti-fraud and anti-manipulation authority to OTC derivatives.

During my tenure as a Commissioner at the CFTC, we brought numerous cases against companies for manipulation and market abuse in the OTC derivatives markets, resulting in hundreds of millions in fines, including cases against Enron for its trading arm Enron Online, AEP, and El Paso, just to name a few. Similarly, under current leadership, the SEC has filed cases seeking to exercise its 10b(5) authority to prevent insider trading in the market for credit default swaps ("CDS").

President Obama's proposed regulatory framework gives the agencies additional enforcement authorities in the OTC derivatives markets. Providing the agencies with additional surveillance capabilities and access to position-level information is essential. In this regard, it is important to remember that while we cannot let the OTC markets off the hook when it comes to fraud and abuse, inserting regulators between sophisticated entities in their negotiation of private contracts is not cost effective and poses moral hazard for the agencies. In addition, if regulators situate themselves so that they are expected to second guess prices that are negotiated OTC, the potential for post-contractual opportunism and litigation risk will no doubt increase. It is the same litigation risk that plagues the securities markets and many have suggested has lead to an increase in foreign listings and the origination of securities in offshore locations.

Homogenizing Private Contracts and Forcing OTC Derivatives Onto Exchanges

Many proposals seek to standardize OTC derivative products. Many commercial users of derivatives have stated that the loss of customization and the flexibility they have come to expect in OTC products will raise the cost of hedging and using derivatives contracts. If they are unable to hedge in a cost effective manner, they will experience greater volatility in their cash flows and thus in their balance sheets. This volatility makes it harder to plan for the future, and makes efficient resource allocation more tenuous. In short, discouraging OTC contracting will make it harder and more costly for many firms to do business.

The Administration's proposal and some of those in Congress, and indeed those naturally supported by exchanges and clearinghouses, seek to homogenize products that have contributed to our ability to mitigate risks. However, it has been the conclusion of my research and experience that the primary impetus for growth in the exchange-traded futures market over the last decade was the parallel growth in the OTC market. This is because intermediaries provide customized risk management solutions to their customers, and they turn around and hedge on a dynamic basis the incremental risks they assume by taking positions in standardized, exchange-traded assets. As a result, forcing OTC derivatives onto exchanges will not necessarily reduce risk or help the exchanges, but more likely will increase risk to clearinghouses and clearing members, and has the potential to cause volumes to contract, which could detract from their heralded qualities of liquidity and price discovery.

A simple example that I used to give to my students to explain the different function of OTC contracts and futures contracts involved the common practice of cash-flow hedging. If an international manufacturer wants to hedge expected monthly billings denominated in a foreign currency over the coming year, it would want a swap with a monthly payment tailored to pay based on the timing and amounts of those expected cash flows. Instead of pays and collects generated by daily mark-to-market that would be required in an exchange-traded contract, and the associated volatility of those cash flows, a swap can reset on a monthly basis, with the hedge offsetting any gains or losses realized on the receivables.

The proposals to standardize derivatives contracts would leave the international manufacturer with less precision in his hedging transaction, require a greater commitment of cash upfront, and increase costs. Cash-flow hedging, a common structure used by small and large businesses across all economic sectors, would require more intermediation to accomplish more frequent marking to market and an increased commitment of margin, as required in a centrally cleared, exchange-traded environment. For various types of risks faced in commercial and business activity, OTC contracts can be more efficient and less costly hedging vehicles than exchange-traded contracts.

It is the business of intermediaries, most notably the swaps dealers and banks who cater to these commercial users, financial entities, and large investors who have a need to reduce or diversify the risks of their business activities, to stand ready to provide quotes for and take the other side of market demand, whether that transaction be complex or plain vanilla. The dealer bank ensures it has the capital and the capacity to assume the risk by balancing that risk against its broader portfolio, laying that risk off against its cash and derivatives books, or trading an offsetting OTC or exchange-traded product.

As I have noted in my research, both OTC dealers and exchanges take and provide collateral, or some type of initial margin, to cover losses in the event of unfavorable price movement and/or default, and this helps mitigate credit risk. In the credit crisis, collateral arrangements became strained as some types lost value (initially subprime related assets) and collateral calls and the withdrawal of financing ensued. Concerns about credit risk of one's counterparties became elevated in the crisis, and this appears to have given rise to proposals to restructure collateral arrangements to adopt a more centralized system, such as a central counterparty, which would collect collateral and mutualize or share the risk among all market users.

Professor Craig Pirrong notes that the linkages created by collateral arrangements among OTC dealers creates a sophisticated network for risk sharing that is less rigid than the approach used by central counterparties to determine margin and mark-to-market. The practice of dealers to adjust their collateral requirements based on the position and balance sheet risks, and their tendency to negotiate the terms of collateral arrangements, facilitates more efficient pricing of default risk than exists in the traditional exchange model.

In the implementation for central counterparty clearing of CDS contracts, many have come to realize that in order to build a collateral pool sufficiently large enough to insure against default, such approaches will raise the requirements and inherent cost for market users of more customized and less standardized products. Whether the costs exceed the marginal benefits that flow from the reduction in counterparty credit risk not already obtained in bilateral collateral arrangements remains to be explored, but the possibility exists that the increase in cost could curtail trading interest in OTC derivatives and make for a substantially less liquid market. In addition, if more standard products are forced onto a central counterparty clearinghouses, intermediaries will face reduced diversification of the collateral pool, which would result in increased risk, discouraging them from providing intermediation to commercials that require more customized products to hedge their risks.

It is this important feature of the private markets, their ability to tailor a product to the user to obtain the most efficient hedge or risk position, that leads me to conclude that as the CFTC and SEC are given greater direct authority over OTC derivatives, their efforts should be focused on ensuring the integrity of the intermediaries, that they have adequate capital and robust risk management protocols, and not focused on forcibly migrating all intermediated and bilateral contracts through a clearinghouse or a central exchange. This would require recognition that banking regulators, as prudential supervisors of OTC dealer banks, are best situated to coordinate that effort. As I have outlined above, a product-focused risk approach will likely result in a contraction of the market for risk management tools and increased risk, doing the opposite of the intended goal of decreased risk.

The Costs of a Ban on Naked CDS and Limits on Speculation

In derivatives markets, and let us take a lesson from a CFTC jurisdictional market, for every contract buyer (long) there is a contract seller (short). A market participant can sell a contract before he buys it, and indeed there is no obligation that he have possession of the underlying commodity before he can enter into a short position. If the contract is cash settled, as most financially settled contracts are, the market participant can hold the contract until maturity and on a net basis pay the difference between his sale price and the closing price at expiration.

Because financial contracts capture risk associated with interest rates, exchange rates, and other broad market risk factors whose value can have implications for all manner of transactions in the domestic and global economy, there has never been a requirement that the holder of a financial futures contract also have a position in the specific underlying instrument.

It is instructive to consider that the CDS market developed out of traditional banking products such as credit guarantees provided by banks to borrowers and its customers at large. For example, the cornerstone of international finance and trade has been based upon the willingness of banks and financial institutions to accept and provide credit guarantees in the form of letters of credit, parent guarantees, and trade credit insurance. However, the activities of lending and extension of credit exposed banks to credit risk that they were unable to hedge and was often concentrated in a particular region, industry, or sector. Banks recognized that they could swap credit guarantees with each other to lower their risk concentrations and diversify their exposures. As with other interbank markets, the market expanded as counterparties and borrowers also recognized the benefits and were willing to pay for the disaggregation of credit risk, while still other banks and institutional investors accepted risk in exchange for a return.

The advent of CDS contracts enabled banks and other lenders to reduce credit risk and diversify it, and this in turn allowed them to expand their financing of a myriad of business activities. During the credit crisis, certain types of assets posed greater risk of default, and as a result, the value of CDS written on those assets increased markedly. A key insight that is often overlooked in this was the manifestation of a properly functioning market. The continued liquidity of the CDS market, particularly in corporate and sovereign issues, provided an important means to assess the credit quality of the assets, providing price discovery and liquidity that sometimes surpassed that of the underlying debt markets themselves (which were also adversely affected by the liquidity crisis).

There are many negative consequences that would result from a ban on naked CDS, including the loss of that liquidity (and the concomitant increase in cost for credit) and price discovery (which would, in turn, make the debt and credit markets less efficient). If government seeks to dictate who may buy and sell CDS, or places limits on those who do not have the underlying debt, the ability of those wishing or needing to transfer those risks will be sharply curtailed. This will preclude banks, lenders, and other entities from extending guarantees, and indeed, will lead them to reduce the availability of credit and increase its cost. Economic activity will be negatively affected as the cost of borrowing for corporations and businesses increase.

It has recently been suggested by securities law advocates that taking a position in an interest rate derivative contract without owning the underlying debt is essentially betting on interest rates and is the same thing as "gambling." Setting aside the short-sightedness of that analogy, it is this same hysteria that gave rise to the ban on certain futures contracts in the 1930s (see Gray) and are behind the proposals to ban naked CDS. Seminal scholarship by Keynes and Working concluded that those traders who take a position on their expectations regarding the future (unpopularly known as speculators), play a critical role in derivatives markets, often taking the other side of commercial market traders who have positions in the underlying assets, thereby increasing liquidity and price efficiency. But the current proposal goes beyond reduction in these aspects of market quality, and threatens to undercut an important mechanism for risk transfer without which the extent and cost of borrowing will be adversely affected. In the current market, we can ill afford such an impact on the debt markets and the ripple effects it would have on economic activity.

Principles-based vs. Rules-based Regulation

The CFTC has a regulatory structure that is principles-based. Instead of prescriptive rules and regulations, the law governing the CFTC sets forth core principles that allow participants to use different approaches to achieve statutory requirements. Under the futures regulatory model, derivatives exchanges are able to implement their business plans under a more disclosure-based, less prescriptive system. New contracts can be introduced without delay and most rules can be instituted or updated with a certification to the CFTC that they are compliant with the statute and the rules.

The principles-based approach places more accountability on the market than a system that requires the regulator to make a determination *ex ante*. We sought to strongly reinforce this accountability effect by ensuring that new products and proposals from the exchanges and self-regulatory organizations, their governance structures, and other critical or "novel" products or services were given sufficient exposure so that investors and other stakeholders had a chance to participate and contribute to regulatory decision-making and enhance effectiveness.

One example that is illustrative of the inherent value of the principles approach in the Commodity Exchange Act and the CFTC's implementation of it is in the approval of exchange-based CDS products. Both the Chicago Mercantile Exchange, regulated by the CFTC, and the Chicago Board Options Exchange, regulated by the SEC, submitted requests for approval to list products based on OTC credit default swaps. Because of its novel structure, the Chicago Mercantile Exchange requested the CFTC to give it prior approval of its CDS product, noting how the product satisfied the core principles of the Act. Upon its satisfaction that the core principles were indeed satisfied, the CFTC granted the approval 90 days after submission of the application. The SEC, working under its rules-based approach, deliberated, required notice and comment before it would approve the applicable rules for the Chicago Board Options Exchange, and did not grant approval of the similar CDS product for almost a year. Examples like this – and there are others – offer a glimpse into the efficiency of the core principles approach, and suggests that such an approach should be considered where appropriate in the securities laws.

The principles-based approach is by no means a panacea, and still requires a strong enforcement culture and keen attention to ensure compliance with the principles and that exchanges do not adopt rules that are anticompetitive. One area with which the CFTC wrestled was in turning back a rule interpretation that, while it was certified to have satisfied core principles, allowed an incumbent exchange to squash a basis contract that would compete with its contracts. The issue of how to encourage competition in the futures market structure with vertically integrated execution and clearing has long been a source of controversy and consternation. Yesterday, Chairman Gensler raised his interest in exploring the concept of fungibility in the futures markets as a way to encourage competition. As I have said, while I believe regulators should not seek to micromanage market structure, I also believe that enabling intermediaries and competitors to utilize innovative contracting structures like Exchange of Futures for Futures ("EFFs") would further competition.

I noted in my prepared testimony, the principles-based approach enables the CFTC to operate more efficiently and results in faster approval of products and rules to accommodate market innovation. It shifts the burden onto the markets to show that their offerings satisfy the core principles. I highly recommend the principles-based approach be introduced into the securities laws, and I think the SEC would find it allows for more flexibility with no loss of command or effectiveness.

Conclusion

It seems a perennial thesis put forth by observers that derivatives markets (or, as investor Warren Buffet referred to them, "financial weapons of mass destruction") pose untold risk to users, are home to unbridled speculation, and are unchecked sources of systemic risk. Yet with respect to both exchange and OTC derivative markets, surprisingly little in the form of objective analysis has been put forth to support the claims. That derivatives are a means for risk transfer, and when used as hedging and risk management tools result in the *reduction* of risk, seems to have been lost in the effort to lay blame for the credit crisis.

Perhaps because OTC derivatives are commonly quantified by the notional amounts underlying the contracts, many assume that those amounts represent amounts at stake or the total risks posed by the OTC derivatives. In fact, a more accurate analysis would involve an assessment of the risks posed by the expected payment streams based on those amounts, and would then take account of natural offsets and deliberate netting and collateral arrangements used to reduce those incremental exposures. The tendency to focus on a $500 to 600 trillion notional amount tends to blur one's appreciation for the collateral, netting, and other mechanisms used by dealers to mitigate risk. Further work focused on the applicability and effect of the mechanisms used by OTC derivatives dealers needs to be undertaken to better inform regulators and to keep from throwing the proverbial baby out with the bathwater.

In a number of proposals that have been introduced in Congress, there are areas in which the effect could be the opposite of that intended. Rather that decreasing systemic risk in the financial system and creating the kind of regulatory clarity that would ensure government effectiveness, certain of the proposals will increase risks and create moral hazards by inserting government into private contract markets that have performed well and delivered respite throughout the crisis. This includes the CDS market and the OTC derivatives markets at large. The impact could be daunting to the financial entities that we still rely on to provide credit and financial services vital to businesses and individuals.

As independent Commissions, you can resist the pressure to arrive upon easy answers in order to expand either agency's jurisdictional territory and look closely at the costs of changes to the regulatory structure. The negotiations and decisions that lie ahead for you will be no less difficult, but you will be better equipped to make those decisions in a manner that preserves the effectiveness and utility of the derivatives markets to manage risks and discover prices.

References

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