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Harmonization of Regulation
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Good morning Chairman Schapiro and Chairman Gensler. My name is Damon Silvers, I am an Associate General Counsel of the AFL-CIO, and I am the Deputy Chair of the Congressional Oversight Panel created under the Emergency Economic Stabilization Act of 2008 to oversee the TARP. My testimony reflects my views and the views of the AFL-CIO unless otherwise noted, and is not on behalf of the Panel, its staff or its chair, Elizabeth Warren. I should however note that a number of the points I am making in this testimony were also made in the Congressional Oversight Panel's Report on Financial Regulatory Reform's section on reregulating the shadow capital markets, and I commend that report to you.[1]

Thank you for the opportunity to share my views with you today on how to best harmonize regulation by the SEC and the CFTC. Before I begin, I would like to thank you both for bringing new life to securities and commodities regulation in this country. Your dedication to and enforcement of the laws that ensure fair dealing in the financial and commodities markets has never been more important than it is today.

Derivatives are a classic shadow market. To say a financial instrument is a derivative says nothing about its economic content. Derivative contracts can be used to synthesize any sort of insurance contract, including most prominently credit insurance. Derivatives can synthesize debt or equity securities, indexes, futures and options. Thus the exclusion of derivatives from regulation by any federal agency in the Commodity Futures Modernization Act ensured that derivatives could be used to sidestep thoughtful necessary regulations in place throughout our financial system.[2] The deregulation of derivatives was a key step in creating the Swiss cheese regulatory system we have today, a system that has proven to be vulnerable to shocks and threatening to the underpinnings of the real economy. The result-- incalculable harm throughout the world, and harm in particular to working people and their benefit funds who were not invited to the party and in too many cases have turned out to be paying for the cleanup.

There are three basic principles that the AFL-CIO believes are essential to the successful harmonization of SEC and CFTC regulation and enforcement, and to the restoration of effective regulation across our financial system:

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[1] Congressional Oversight Panel, Special Report on Regulatory Reform, at 22-24 (Jan. 29, 2009), available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

[2] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

1. Regulators must have broad, flexible jurisdiction over the derivatives markets that prevents regulatory arbitrage or the creation of new shadow markets under the guise of innovation.

2. So long as the SEC and the CFTC remain separate agencies, the SEC should have authority to regulate all financial markets activities, including derivatives that reference financial products. The CFTC should have authority to regulate physical commodities markets and all derivatives that reference such commodities.

3. Anti-fraud and market conduct rules for derivatives must be no less robust than the rules for the underlying assets the derivatives reference.

The Administration's recently proposed Over-the-Counter Derivatives Markets Act of 2009 ("Proposed OTC Act") will help to close many, but not all, of the loopholes that make it difficult for the SEC and the CFTC to police the derivatives markets. It will also make it even more important that the SEC and the CFTC work together to ensure that regulation is comprehensive and effective.

<u>Regulators must have broad, flexible jurisdiction over the entire derivatives market</u>

Derivatives as a general matter should be traded on fully regulated, publicly transparent exchanges. The relevant regulatory agencies should ensure that the exchanges impose tough capital adequacy and margin requirements that reflect the risks inherent in contracts. Any entity that markets derivatives products must be required to register with the relevant federal regulators and be subject to business conduct rules, comprehensive recordkeeping requirements, and strict capital adequacy standards.

The Proposed OTC Act addresses many of the AFL-CIO's concerns about the current lack of regulation in the derivatives markets. If enacted, the Proposed OTC Act would ensure that all derivatives and all dealers face increased transparency, capital adequacy, and business conduct requirements.[3] It would also require heightened regulation and collateral and margin requirements for OTC derivatives.

The Proposed OTC Act would also require the SEC and CFTC to develop joint rules to define the distinction between "standardized" and "customized" derivatives.[4] This would make SEC/CFTC harmonization necessary to the establishment of effective derivatives regulation.

The AFL-CIO believes that the definition of a customized contract should be very narrowly tailored. Derivatives should not be permitted to trade over-the-counter simply because the counterparties have made minor tweaks to a standard contract. If counter-parties are genuinely on opposite sides of some unique risk event that exchange-trading

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[3] Available at http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf

[4] Proposed OTC Act § 713(a)(2) (proposing revisions to the Commodity Exchange Act, 7 U.S.C. 2(j)(3)(A)).

could not accommodate, then they should be required to show that that is the case through a unique contract. The presence or absence of significant arms-length bargaining will be indicative of whether such uniqueness is genuine, or artificial.

In a recent letter to Senators Harkin and Chambliss, Chairman Gensler flagged several areas of the Proposed OTC Act that he believes should be improved. [5] The AFL-CIO strongly supports Chairman Gensler's recommendation that Congress revise the Proposed OTC Act to eliminate exemptions for foreign exchange swaps and forwards. We also strongly agree with Chairman Gensler that mandatory clearing and exchange trading of standardized swaps must be universally applicable and there should not be an exemption for counterparties that are not swap dealers or "major swap participants".

<u>The SEC should regulate financial markets and the CFTC should regulate commodities markets</u>

The SEC was created in 1934, due to Congress' realization that "national emergencies… are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit."[6] As a result of the impact instability in the financial markets had on the broader economy during the Great Depression, Congress gave the SEC broad authority to regulate financial markets activities and individuals that participate in the financial markets in a meaningful way.[7]

As presently constituted, the CFTC has oversight not only for commodities such as agricultural products, metals, energy products, but also has come to regulate—through court and agency interpretation of the CEA—financial instruments, such as currency, futures on U.S. government debt, and security indexes.[8]

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[5] Letter from Gary Gensler, Chairman of the Commodity Futures Trading Commission, to The Honorable Tom Harkin and The Honorable Saxby Chambliss, August 17, 2009, page 4, *available at* http://tradeobservatory.org/library.cfm?refid=106665

[6] 15 U.S.C. § 78b.

[7] See generally The Securities Act of 1933 (15 USC § 77a et seq.); The Securities Exchange Act of 1934 (15 USC § 78a et seq.); The Investment Company Act of 1940 (15 USC § 80a-1 et seq.); The Investment Advisers Act of 1940 (15 USC § 80b-1 et seq.).

[8] 7 U.S.C. § 1a(4) provides the CFTC with jurisdiction over agricultural products, metals, energy products, etc.

See *Commodity Futures Trading Com'n v. International Foreign Currency, Inc*., 334 F.Supp.2d 305 (E.D.N.Y. 2004), *Commodity Futures Trading Com'n v. American Bd. of Trade, Inc.*,803 F.2d 1242 (2d Cir 1986) discussing the CFTC's authorities with regard to currency derivatives.

Since 1975, the CFTC has determined that all futures based on short-term and long-term U.S. government debt qualifies as a commodity under the CEA. See CFTC History, available at http://www.cftc.gov/aboutthecftc/historyofthecftc/history_1970s.html.

Other financial products regulated by the CFTC include security indexes, *Mallen v. Merrill Lynch*., 605 F.Supp. 1105 (N.D.Ga.1985).

So long as two agencies continue to regulate the same or similar financial instruments, there will be opportunities for market participants to engage in regulatory arbitrage. As we have seen on the banking regulatory side and with respect to credit default swaps, such arbitrage can have devastating results.

As long as the SEC and the CFTC are separate, the SEC should regulate all financial instruments including stocks, bonds, mutual funds, hedge funds, securities, securities-based swaps, securities indexes, and swaps that reference currencies, U.S. government debt, interest rates, etc. The CFTC should have authority to regulate all physical commodities and commodities-based derivatives.

We recognize that the proposed Act does not in all cases follow the principles laid out above. To the extent financial derivatives remain under the jurisdiction of the CFTC, it is critical that the CFTC and the SEC seek the necessary statutory changes to bring the CFTC's power to police fraud and market manipulation in line with the SEC's powers. In this respect, we are heartened by the efforts by the CFTC under Chairman Gensler's leadership to address possible gaps in the Administration's proposed statutory language. A vigorous and coordinated approach to enforcement by both agencies can in some respects correct for flaws in jurisdictional design. They cannot correct for lack of jurisdiction or weak substantive standards of market conduct.

In his letter to Senators Harkin and Chambliss, Chairman Gensler raised concerns about the Administration's proposal for the regulation of "mixed swaps", or swaps whose value is based on a combination of assets including securities and commodities. Because the underlying asset will include those regulated by both the SEC and the CFTC, the Administration proposes that both agencies separately regulate these swaps in a form of "dual regulation." Chairman Gensler expresses concern that such dual regulation will be unnecessarily confusing, and suggests instead that each mixed swap be assigned to one agency or the other, but not both. In that proposed system, the mixed swap would be "primarily" deriving its economic identity from either a security or a commodity.[9] Under the Chairman's view, only one agency would regulate any given mixed swap, depending on whether the swap was "primarily" a security- or a commodity-based swap.

Chairman Gensler's proposal certainly has a great deal of appeal – it's simpler, and eliminates the concern that duplicative regulation becomes either unnecessarily burdensome, or worse, completely ineffective. One could imagine a situation where each agency defers to the other, leaving mixed swaps dealers with free reign to develop their market as they see fit.

But a proposal that focuses on the boundary between an SEC mixed swap and a CFTC mixed swap will run into a clear problem. There are swaps that are not primarily either security- or commodity-based: in fact, by design, they are swaps that, at the time of contract, are exactly 50/50, where the economic value of the SEC-type asset is equivalent to the economic value of the CFTC based asset. 50/50 swaps aren't that unusual, and Chairman Gensler's approach does not address what to do in those instances.

[9] *Id.*

These kinds of boundary issues become inevitable when we decide not to merge the two agencies. In order to prevent these problems from becoming loopholes, a solution must either eliminate the boundary—e.g., the Administration's dual regulation proposal—or it must adequately police that boundary. One potential alternative would be to form a staff-level joint task force between the CFTC and the SEC to ensure that these 50/50 swaps—those that are neither obviously SEC-swaps nor CFTC-swaps—would be regulated comprehensively, and consistently, across the system.

Anti Fraud and Market Conduct Rules

In considering enforcement issues for derivatives, it is critical to consider the appropriate level of regulation of the underlying assets from which these derivatives flow. Some of the strongest tools in the agencies' toolboxes are anti-fraud and market conduct enforcement. Derivatives must be held at a minimum to the same standards as the underlying assets. The Administration's Proposed OTC Derivatives Act makes important steps in this direction. However, there will be a continuing problem if the rules governing the underlying assets are too weak.

Here the CFTC's current statutory framework is substantially weaker in terms of both investor protection and market oversight than the SEC. The Commodities Exchange Act (CEA) does not recognize insider trading as a violation of the law. This is a serious weakness in the context of mixed derivatives and both financial futures and derivatives based on financial futures. It also appears to be an obstacle to meaningful oversight of the commodities markets themselves in the light of allegations of market manipulation in the context of the recent oil price bubble.

Similarly, the CEA has an intentionality standard for market manipulation, while the SEC operates under a statutory framework where the standard in general is recklessness. Intentionality as a standard for financial misconduct tends to require that the agency be able to read minds to enforce the law. Recklessness is the proper common standard.

Rules versus Principles

The Treasury Department's White Paper on Financial Regulatory Reform suggests there should be a harmonization between the SEC's more rules-based approach to market regulation and the CFTC's more principles-based approach.[10] Any effective system of financial regulation requires both rules and principles. A system of principles alone gives no real guidance to market actors and provides too much leeway that can be exploited by the politically well connected. A system of rules alone is always gameable.

Unfortunately, in the years prior to the financial crisis that began in 2007 the term "principles based regulation" became a code word for weak regulation. Perhaps the

[10] *Financial Regulatory Reform: A New Foundation*. Department of the Treasury (June 17, 2009). See also http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

most dangerous manifestation of this effort was the Paulsen Treasury Department's call in its financial reform blueprint for the weakening of the SEC's enforcement regime in the name of principles based regulation by requiring a merged SEC and CFTC to adopt the CEA's approach across the entire securities market.[11]

The SEC and the CFTC should build a strong uniform set of regulations for derivatives markets that blend principles and rules. These rules should not be built with the goal of facilitating speedy marketing of innovative financial products regardless of the risks to market participants or the system as a whole. In particular, the provisions of the Commodities Exchange Act that place the burden on the CFTC to show an exchange or clearing facilities operations are not in compliance with the Act's principles under a "substantial evidence" test are unacceptably weak, and if adopted in the area of derivatives would make effective policing of derivatives' exchanges and/or clearinghouses extremely difficult.

It remains a mystery to us why "innovation" in finance is uncritically accepted as a good thing when so much of the innovation of the last decade turned out to be so destructive, and when so many commentators have pointed out that the "innovations" in question, like naked credit default swaps with no capital behind them, were well known to financial practitioners down through the ages and had been banned in our markets for good reason, in some cases during the New Deal and in some cases earlier.

This approach is not a call for splitting the difference between strong and weak regulation. It is a call for building strong, consistent regulation that recognizes that the promotion of weak regulation under the guise of "principles based regulation" was a major contributor to the general failure of the financial regulatory system.

Conclusion

The last two years have shown us the destructive consequences of the present system—destructive not only to our overall economy, but also to the lives and livelihoods of the men, women, and families least positioned to weather these storms. We have seen firsthand how regulatory arbitrage in the financial markets create tremendous systemic risks that can threaten the stability of the global economy. Derivatives are a primary example of how jurisdictional battles among regulators can result in unregulated and unstable financial markets. We urge you to work together to create a system that will ensure that nothing falls through the cracks when the SEC and the CFTC are no longer under your collective leadership.

[11] http://www.treas.gov/press/releases/reports/Blueprint.pdf