GOOD GOVERNMENT: Making it our Mission, not just a Slogan.
Remarks by Commissioner Scott D. O'Malia,

University of Notre Dame Business Law Forum
September 21, 2012

It's a pleasure to address the Business Law Forum. I would like to extend a special thank you to Professor Patricia O'Hara for her generous offer to come back to South Bend on one of the most important weekends of the year. It has been some time since I was last here, but believe it or not, I was born here and lived here until I was 6 years old and was at that time a fan of the Fighting Irish.

It was also during these formative years when I met Professor O'Hara. Back then Professor O'Hara was a first year law student from California and a friend of my uncle. On a couple of occasions, Ms. O'Hara would join us for a nice home cooked meal.

So nearly forty years later, it is great to be back to see old friends, to see my old neighborhood and to watch the game – even if I'm not rooting for the home team.

As much as I'd like to spend the next half hour talking about tomorrow's game and the rivalry between the two schools, I'll stay on topic and provide you some perspective on the CFTC's implementation of the Dodd-Frank Act.

The title of my speech today is "Good Government: **Making it our Mission, not just a Slogan**.**"** I would like to use this speech to highlight some of the very serious concerns I have with the CFTC's rulemaking process, including a lack of transparency into the schedule and compliance requirements as well as the tenuous connections some of our rules have to the statute they are based on. It isn't good enough to follow the statute when it suits us; we must do so each and every time.

Presently, the Commission is in the midst of recommending over 50 detailed rules and rule changes in order to implement the Dodd-Frank Act. I believe, in our rush to implement rules, we have taken shortcuts in defining the critical terms and applied our rules inconsistently.

Today, I would like to provide three specific examples where the Commission has, in my opinion, failed the "Good Government" test in its rulemakings and must make immediate corrections. These examples will highlight the fact that the Commission is overreaching in its rulemakings and that such action isn't limited to a subset of rules, but is more pervasive. At the end of my remarks, I will provide a little career advice and offer some encouragement to both students and faculty here to contribute to this important policy debate.

Overview of Dodd-Frank

As you know, the Dodd-Frank Act was signed into law in July 2010, just over two years ago. It was enacted in response to the global financial meltdown in 2008 when our country witnessed the collapse of large financial institutions and significant government intervention in the form of bailouts. This legislation was a massive undertaking intended to bring the $300 trillion U.S. swaps market under CFTC oversight. Thus far, pursuant to Dodd-Frank, the CFTC has proposed over 50 draft regulations and finalized 39 rules. I expect the Commission will complete most of the rulemakings by the end of the year.

According to the law firm Davis Polk, the entire Dodd-Frank Act totaled 949 pages of statutory text. Thus far, only 30 percent of the rules have been completed and the total number of pages of the regulation has already exceeded 8,800 pages – a 1:10 statute to rule ratio.

For the past two years, the Commission has taken a very aggressive approach to implementing these new rules – a strategy I have called High Frequency Regulation. I use this phrase because the speed with which we enact these new regulations reminds me of the trading, called "high frequency trading." The speed of orders to buy and sell contracts is so great that most of the time computers (and not humans) submit the actual orders. I think this is a good analogy, because industry participants have been barraged with so many new rules within such a short time that sometimes, it is not humanly possible to make sense of the changes that are taking place.

This process of high-speed regulation will invariably lead to regulatory inconsistences, blatant mistakes, uncertainty and unexpected outcomes. In a mad rush to implement the rules, the Commission quite often forgets to make sure that all these rules should work together to achieve the overall objectives of enhancing transparency and reducing systemic risk.

Swap Data Reporting Rules

In my first example, I would like to point out a serious concern with the rule implementation of the Swap Data Repository license applications. One of the main problems leading to the financial crisis was an excessive amount of risk taking. Obviously, some institutions failed to properly manage such risk and regulators didn't have insight into the extent of that risk. As a result of these failures, Congress mandated that all swap data be reported to centralized record-keeping databases, called swap data repositories (SDRs).

This process of swaps reporting is the cornerstone of the new derivatives regime. It intends to increase the transparency and integrity of the derivatives markets. To implement the legislation, the CFTC published 234 pages of regulations requiring SDRs to register and to comply with technological standards in order to report specific swap data for real-time public reporting or for regulatory use.[1] Registration of SDRs seems like a pretty straightforward process. But even then the Commission has managed to come up with inconsistent outcomes.

For example, one regulatory provision explicitly requires SDRs to make public (or "pull," as the regulation calls it) market data into a searchable web interface that should be updated every

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[1] See Real Time Public Reporting of Swap Transaction Data, 17 CFR Part 43 (Jan. 9, 2012); Swap Data Recordkeeping and Reporting Requirements, 17 CFR Part 45 (June 12, 2012); Swap Data Repositories: Registration Standards, Duties and Core Principles Regarding Rulemaking, 17 CFR Part 49 (October 31, 2011).

thirty seconds.[2] However, during the course of the Commission's review of the SDR applications, I heard numerous complaints that standards had changed and that they were contrary to our reporting rules.

Recently, the Chicago Mercantile Exchange (CME) has sent the Commission a very strong letter outlining its frustration with the SDR registration process and with the Commission's "new" interpretation of the published rules.[3] CME points out in the letter that when it requested to see "recent directives" in writing, it was told that the Commission "did not have [anything in writing] and should not expect to receive a written confirmation of these new directives."[4] I find it frustrating that the rules are being adjusted after they have been approved and I can only imagine the frustration market participants must feel when the standards are changed with deadlines looming. If that is what has transpired, I can assure you this is not good government.

Time for Transparent Implementation Guidelines

It is not easy to comply with regulations when the goal posts are constantly moving. To avoid outcomes like this, I am calling on the Commission to issue guidance outlining the registration process for swap data repositories that would bring critical transparency to the rule implementation process and guarantee that all applicants will be treated similarly. It has taken over 7 months to approve registration of the first two SDRs; and I thought that our regulations provided for a pretty straight forward process.

If the SDR process is any indication of the challenges of registering just five entities, then I fear what is in store for both the swap execution facilities (SEFs) and Swap Dealer registration applications. The complexity of approving applications for a wide variety of SEFs will require

[2] Real Time Public Reporting of Swap Transaction Data, 17 CFR Part 43, 77 Fed. Reg. 1182 at 1195 (Jan 9. 2012) (stating that ""publicly disseminate" should mean making the data readily available in a non-discriminatory manner to those who wish to access it, rather than pushing it to market participants, data vendors, news media, etc.").

[3] CME letter to Rick Shilts, regarding Chicago Mercantile Exchange Inc. SDR Application (Aug. 24, 2012) ("CME letter") (attachment).

[4] CME letter at 1.

the Commission to develop flexible principles-based regulations and provide transparent implementation guidelines if the Commission is going to foster a diverse and competitive market.

With regard to swap dealers, they must begin their compliance efforts on Oct. 12, 2012. Market participants must be able to determine whether or not they will need to register as swap dealers. Again, I urge the Commission and the National Futures Association to provide clear and consistent guidelines for applicants to follow.

The Proposed Cross Border Guidance does not make for good government.

The second example of the Commission failing to live up to the good government standard is the Commission's proposed Cross Border Guidance. The overall objectives of the Guidance are to (1) clearly define the scope of the extra-territorial reach of Title VII of Dodd-Frank and to (2) reinforce the Commission's commitment to the goals of the G-20 summit by providing a harmonized approach to regulation of swap dealings and by ensuring a level playing field and avoiding fragmentation of markets, protectionism, and regulatory arbitrage.[5]

However, in trying to implement these standards, the Cross Border Guidance applied a vague, overbroad and truthfully, unprecedented regulatory reach of the Dodd-Frank rules. Not only do these rules exceed Commission authority, but they also trample on foreign regulatory authority and put U.S. financial institutions and commercial firms at a competitive disadvantage. Despite its objective, this rule couldn't do more to confuse the objective of coordinated global oversight.

Rulemaking vs. Guidance

[5] The G-20 2009 commitment, as revisited by the G-20 in 2010, was to "implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage." Communiqué issued from the meeting of the Group of Twenty Finance Ministers and Central Bank Governors held in Gyeongju, Korea on October 23, 2010.

First, given the significant costs that it imposes on industry participants, the Guidance should have been issued as a proposed rulemaking in order to give industry participants an opportunity to assess and comment on the Commission's cost-benefit analysis. In addition, the proposal creates a new type of regulated entity, called "conduit," and establishes specific duties and obligations on non-U.S. entities. This clearly exceeds the scope of the statutory mandate, which explicitly states that Dodd-Frank shall apply to activities outside of the United States only if such activities have a direct and significant connection with the activities in the United States.[6]

This provision was drafted by Congress as a limitation on our authority, yet the proposed Guidance expands the authority by empowering the Commission to find virtually any swap to have a direct and significant impact on our economy. Such expansion of authority leads to specific application of U.S. rules, including transaction rules to non-U.S. entities that have set off alarm bells in foreign capitals all over the globe. The Commission has received an unprecedented number of letters from foreign regulators.[7]

The proposal should be re-drafted to interpret "the direct and significant" connection and should be issued as a proposed rule. This will not delay foreign compliance, as the Commission is prepared to issue broad exemptive authority for 1 year.

Statutory Overreach Creates Competitive Imbalance for U.S. Firms

In addition, the definition of U.S person as drafted in the proposed Guidance takes an overbroad extra-territorial reach and sweeps many entities that are outside the U.S. into the CFTC's jurisdiction. In one example, the Guidance requires non-U.S. counterparties to treat overseas branches of U.S. banks (unlike affiliates of U.S. banks) as U.S. persons. If these foreign companies do enough business with foreign-based U.S. banks, they will be categorized as U.S. persons.

[6] 7 U.S.C. §2(i).
[7] http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1234

The Commission has heard concerns from a number of U.S. banks that foreign competitors abroad are already trying to entice customers away by warning them that U.S. regulations will raise costs of doing business with U.S. banks and apply standards beyond those being contemplated in foreign jurisdictions. I cannot support a Commission proposal that will put U.S. firms at a competitive disadvantage to foreign banks, especially those that operate in the United States.

As I mentioned before, the Commission does not define the "direct and significant" connection with activities in the United States,"[8] but instead, issues a rule that seems to declare that any trade, regardless of where it takes place, should be within the CFTC's reach.

For example, under the Commission's "Entity Definition" rules, a U.S. swap dealer has to register with the Commission and comply with all regulatory requirements only if the swap dealer's annual gross notional level of swap dealing activity exceeds $8 billion (de minimis exemption).[9] As a result, a non-U.S. swap dealer will have to register with the Commission as a swap dealer once it engages in the swap dealing activity that exceeds the de minimis level (i.e. $8 billion).

However, it defies logic as to why, under the Guidance, each and every swap transaction between one or more U.S. persons or counterparties other than a swap dealer (or major swap participant) satisfies the direct and significant threshold. Such swap transactions will be subject to certain regulatory requirements, including clearing, exchange trading, public reporting, and large swaps trader reporting.

It is important that the Commission faithfully interpret the statute. The definition of U.S. person should be narrowed to include only those entities that are residents of the United States, have a principle place of business in the United States, or have majority U.S. ownership, and should

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[8] 7 U.S.C. § 2(i).
[9] See Further Definition of "Swap Dealer" ("Entity Definition") 77 Fed. Reg. 30596 (May 23, 2012).

exclude a foreign affiliate or subsidiary of a U.S. end user, guaranteed by that end user. Our rules should respect the regulatory authorities of other countries.

In addition, the "direct and significant" clause must be clearly interpreted and consistently applied among all entities. Specifying those activities and thresholds that do impose an impact on the economy will allow the Commission to be more specific as to how these impacts can be mitigated through clearing and to determine whether other transaction rules must be applied.

Finally, the Cross Border Guidance must be clear about its definition of "substituted compliance." The proposed Guidance indicates that the CFTC will review the comparability of non-U.S. regulation with the CFTC rules. Given the Commission's broad discretion, there is a good chance that some areas of foreign regulations will not have a comparable regime, but other areas may meet the Commission's standard. A rule-by-rule analysis presents a host of issues that worry U.S. and foreign businesses as they will have to deal with disparate regulatory requirements and piecemeal regulatory compliance. Besides, piecemeal review undermines the coordinated regulatory effort that G-20 members have agreed to support.

The reality is that today's swaps markets are global in nature and interdependent. The Commission needs to engage with foreign regulators and coordinate their application to eliminate redundancy and inconsistency among the rules.

Swap Rules Drive Shift to Regulatory Security of Futures Markets.

Finally, I would like to provide one last example where a combination of rules has created a trading environment that has become too complicated and too costly and thus has driven customers to seek protection from the swaps rules by shifting their positions to the futures markets. After two years of Commission rulemakings, including reporting requirements rules Swap Dealer rules, block trade rules and the proposed swap execution facilities rules, IntercontinentalExchange (or ICE) has announced its plans to list trillions of dollars of energy swap contracts as futures contacts instead of retaining the swap designation. ICE will become the first exchange to take such a step ahead of new financial regulations.[10]

This move may reduce flexibility in terms of tailoring the contracts to meet specific risk needs, but it does offer far greater regulatory certainty and does allow deeply liquid markets to hedge commercial risk. It also allows participants the ability to margin their trades in one account rather than two separate segregation regimes, which is much more capital efficient. On a bilateral basis, commercial end users will be able to use the OTC swaps market to hedge bespoke risk without fear of becoming a swap dealer, but will likely pay more for these transactions depending on the final capital and margin rules.

I certainly don't believe it was the intent of Congress or the Commission to draft rules that would drive people out of the swaps market, but I believe the regulatory uncertainty was so great that energy markets voted with their pocket-books and moved their trading business from the complex regulatory nightmare of the swaps markets to the well-functioning futures markets.

Now, I'm not certain that other asset classes like interest rates or credit default swaps will be able to find the same relief from the regulations, but I am certain that market participants at all levels and in all asset classes are discussing a possible move to the futures markets.

Time will tell to what extent Commission regulations impacted the derivatives market, as we continue to finalize the SEF rules, critical capital and margin rules for uncleared trades, and the Volcker rule. Each of these rules will have real consequences for the swaps market.

I have shared with you some of the challenges the Commission is facing in promulgating the Dodd-Frank rules. Now I want to circle back to the title of the speech and ask -- do you think the Commission has made "Good Government" its mission, or merely its slogan?

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[10] http://www.marketwatch.com/story/ice-to-transition-cleared-energy-swaps-to-futures-2012-07-30-174851139.

These issues deserve careful attention and would certainly benefit from a more lengthy debate. I believe we need to do a better job of understanding, justifying and explaining our regulatory decisions before we enact them, not after.

I appreciate Notre Dame's consistent focus on studying the important interaction between business and the legal system. Both the Law School and Business Schools have joined this debate. These issues are far from being resolved and we will inevitably revisit many of the hasty decisions we are making today – either through exemptive orders, staff no-action letters, or reconsideration of the rules.

Career Advice

For the students and the faculty in the audience, I would encourage you to focus your attention on the relationship between markets and regulation. Without a doubt, the government's involvement in financial markets has expanded significantly. This demands that students develop some experience in both the business and policy space. It will be important for both the business majors and future lawyers to understand how to comply with a more prescriptive rules-based regime that is in your future. For the future lawyers, we have probably created lifetime employment if you focus on markets and regulatory compliance.

For the economics majors, I hope we can draw on your expertise to improve our knowledge and capability in executing our oversight responsibilities. I have insisted that the Commission should focus on expanding its surveillance capability to utilize computer aided surveillance to sort massive amounts of transaction and order data. We need to adapt our oversight program to keep up with the high speed, automated trading environment currently employed by the industry. We need future graduates like you to provide innovative ideas with regard to market analysis and strong risk management.

Another bit of advice I would give you is to question the status quo. Obviously, hindsight is 20/20, but certainly we could have used more objective evaluation of the leverage and risk assumed by financial institutions in the lead up to 2008 crisis. In the energy space, following the collapse of Enron in 2002, energy firms and traders were forced to reevaluate the over-the-counter market and counterparty credit exposure. Again, with the benefit of hindsight, the move to clearing energy over-the-counter swaps was the only means of reducing counterparty credit exposure, an important evolutionary step in that market. I can't begin to predict the evolution the futures and swaps markets are about to experience, but it certainly will provide an interesting experiment for academics to ponder for years to come.

Conclusion

To conclude, I want to emphasize the importance of applying principles of good government to the CFTC's mission. For rules not yet finalized, this means taking into account the views of market participants and adopting final rules that are clear, consistent and that create a level playing field. For rules already finalized, this means providing transparent implementation guidance that is consistent with the final rules. Last but not least, this means being aware of the consequences of finalized and implemented Commission regulations on market activity and maintaining the flexibility to reassess and revise such regulations where appropriate.

Thank you again for giving me the opportunity to speak. Go Blue!