



## **Commodity Futures Trading Commission**

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# **Testimony**

## **Testimony of Ananda Radhakrishnan Director, Division of Clearing and Intermediary Oversight Before the House Committee on Agriculture**

**November 20, 2008**

Chairman Peterson, Ranking Member Goodlatte, and other distinguished Members of the Committee, I am pleased to have this opportunity to appear today to discuss risk management for over-the-counter credit default swaps (CDS). My name is Ananda Radhakrishnan and I serve as the Director of the Division of Clearing and Intermediary Oversight at the CFTC. I am here today testifying in that capacity and not on behalf of the Commission.

Acting Chairman Lukken testified before the Committee on October 15 on this subject, so I will try not to be redundant, but rather focus on recent events related to the CDS markets, including the ongoing process to develop a clearing solution for CDS products and the Memorandum of Understanding (MOU) recently signed by the CFTC, the Federal Reserve (Fed), and the Securities and Exchange Commission (SEC).

As the Committee is aware, concerns have been raised regarding the role that over-the-counter CDS products may have played in contributing to the recent credit crisis. Staff of the CFTC, the Fed, and the SEC believes that centralized clearing of CDS instruments would bring transparency and financial integrity to the CDS market, which would be an important step in resolving the current crisis and restoring the strength and integrity of the U.S. financial markets as a whole. As such, the agencies have been working together to identify potential clearing solutions for CDS products.

Several entities – most prominently, the Chicago Mercantile Exchange (CME) and the Intercontinental Exchange (ICE) – recently have submitted proposals to clear CDS. The primary federal regulator for these entities will be the CFTC (for the CME proposal) and the Fed (for the ICE proposal). In addition, the entities plan to obtain exemptions from the SEC from certain securities law provisions. During the past several weeks, staff of the CFTC, Fed, and SEC have engaged in a collaborative review of these entities to evaluate their proposals for compliance with applicable statutory and regulatory requirements, such as the core principles for derivatives clearing organizations (DCOs) established by the Commodity Futures Modernization Act of 2000 (CFMA).

Another example of agency cooperation is the MOU entered into by the CFTC, Fed, and SEC. Generally speaking, the MOU is a statement of intent to cooperate, coordinate and share information in connection with the respective oversight responsibilities of each agency regarding central counterparties for CDS.

Among its specific provisions, the MOU provides that the agencies will consult with each other and share information regarding matters such as: i) the review and approval of any proposed central counterparty; ii) material proposed changes to the rules, policies or procedures of a central counterparty; and iii) the financial condition, risk management systems, internal controls, liquidity and financial resources, operations, and governance of central counterparties. The MOU also contains provisions regarding permissible uses of information exchanged under the MOU and confidentiality of that information.

The MOU deliberately does not address the specifics of any particular clearing proposal for CDS, nor does it commit any of the agencies to take any action (or refrain from any action) with respect to any particular clearing proposal or central counterparty. It recognizes the importance of efficient supervision and regulation of central counterparties to reduce duplicative efforts. It avoids, however, addressing any issues respecting the jurisdictional authority of the agencies over various central counterparties.

However, as the MOU expressly recognizes, a central counterparty for CDS may be one or more of the following: a state-chartered bank that is a member of the Fed, a DCO under the jurisdiction of the CFTC, or a Clearing Agency under the jurisdiction of the SEC. This reflects the statutory scheme set up by Congress with the passage of the CFMA.

Pursuant to Section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which was enacted as part of the CFMA, over-the-counter derivative instruments may be cleared by any multilateral clearing organization (MCO) that is regulated by the CFTC, the SEC or the Fed (or by foreign clearing organizations under certain circumstances). Over-the-counter derivative instruments are defined expansively in Section 408(2) of FDICIA to include, among other things, any agreement, contract, or transaction that is a credit spread or credit swap or that is a swap on one or more occurrences of any event, equity security, or other equity instrument, debt security or other debt instrument. In short, instruments known as CDS fall under FDICIA's definition of over-the-counter derivative instruments.

Contemporaneously with authorizing the clearing of over-the-counter derivative instruments by any MCO, Congress excluded the trading of over-the-counter financial derivative instruments from CFTC and SEC jurisdiction. However, there remains legal uncertainty whether the act of clearing changes the legal status of an OTC derivative. We believe Congress intended to bring the benefits of multilateral clearing to the over-the-counter credit markets without imposing legal ambiguity and regulatory redundancy that would create a disincentive to clearing these unregulated instruments. That principle is recognized in the MOU that was entered into last week, which emphasized the importance of promoting the effective and efficient supervision and regulation of central counterparties and reducing duplication of effort by the agencies.

Over the years, through supervision of the DCOs, the CFTC has developed extensive institutional knowledge and regulatory expertise regarding derivatives clearing. Further, the clearing model used by DCOs has worked well for many years for a wide variety of products, without a single clearinghouse default. DCOs process millions of transactions per day, using fully automated clearing systems that reduce the likelihood of processing delay and error. This model should work equally well for CDS transactions.

We at the CFTC will continue to work collaboratively and cooperatively with our colleagues at the Fed and the SEC, and with international regulators, to bring transparency and financial integrity to the CDS market through clearing and infrastructure improvements, and to enhance and improve effective risk management and market oversight. It is our hope that these efforts will help restore the strength and integrity of the U.S. financial markets.

Thank you for your leadership on this critical issue. I am pleased to answer any questions you may have.