Speech

Pittsburgh Principles and Regulatory Realities: Remarks before the International Regulators Conference

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Thank you, Anna [Paulson], for that kind introduction. I and others in this room owe a debt of gratitude to you and your colleagues at the Federal Reserve Bank of Chicago, who have contributed so much to our knowledge on central clearing, financial crises, and financial regulatory policy. I appreciate the opportunity to speak with fellow regulators this morning and especially look forward to the discussions that will take place later today. Before I begin, I must give my standard disclaimer that the views I represent are my own and may not reflect the views of the Securities and Exchange Commission (SEC) or my fellow Commissioners.

It is hard for me to believe that the financial crisis is a decade behind us. The reality of how long ago the crisis was came home to me when I was talking with a young colleague recently who reminded me that she was in middle school when the crisis happened. The crisis had not even struck her as a particularly noteworthy event in her teenage years. For most of us, by contrast, memories of the crisis are deep and continue to shape our approaches to our jobs as regulators.

Our shared memories of the crisis may not translate into identical views about regulatory solutions. I will speak this morning about some of my own concerns about the crisis narrative and the regulatory solutions that we have crafted in response. More than any other message, however, I want to underscore the importance of international goodwill and cooperation as we confront our shared task of regulating global financial markets. It is the relationships we forge at events like this one that will help us to work more effectively together during periods of market stress.

As you all know, in September 2009, the heads of the Group of 20 countries met in Pittsburgh, Pennsylvania. One of the products of that summit was a set of principles to guide reform efforts related to over-the-counter derivatives. The G20 leaders agreed that "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."[1] The agreement further called for OTC derivatives to be reported to trade repositories and for non-cleared derivatives "to be subject to higher capital requirements."[2]

Now, for those of you who are not from the US, there is one thing you need to know about Pittsburgh: its rival is Cleveland, Ohio. The rivalry primarily manifests itself in a bitter football—American football—rivalry between the Pittsburgh Steelers and the Cleveland Browns. The tensions, however, run deeper than sports. The two cities are competitors because they are so similar. Just over one hundred miles apart, the two cities are both former great centers of steel production. They now are both home to world-class universities and are both thriving biotech hubs. Why does any of this matter in today's discussions? I am from Cleveland. What that means is that I am naturally disposed to dislike anything that was produced in Pittsburgh.

So, back to those G20 Pittsburgh Summit principles for OTC derivatives. . . . Let us just say that they did not start off on a good foot with me. Had those principles been crafted in Cleveland, we might be having a different conversation

today.

In reality, my skepticism of the plan for OTC derivatives does rest on something a bit more substantive than a geographic rivalry. I worry that the principles miss an important thread in the fabric underlying the financial crisis, a thread that could once again unravel and contribute to a future crisis. That thread is the role that regulators and regulation can play in a crisis and the limits on regulators' ability to safeguard the financial system through direct participation in decision-making.

There is plenty of blame to go around for the crisis. I am still baffled at how little large, sophisticated financial firms knew about their exposures to one another, as evidenced by the chaos that ensued as firms struggled to determine how much exposure they had to whom as markets locked up. Recordkeeping issues, without anything more, can be devastating. We have seen this principle in other crises, such as the Paperwork Crisis in the United States in the 1960s, which led to the downfall of many broker-dealers and the need to close the New York Stock Exchange every Wednesday to allow remaining firms to clear up their backlogs.[3] Of course, in the years leading up to the 2007-2009 crisis, market participants did many other things wrong, including allowing mortgages to be originated, securitized, and sold without any meaningful due diligence and trading derivatives based on these securitized mortgages without proper collateral protection.

Speaking of derivatives based on securitized mortgages, people often point to American International Group (AIG) as the poster child for the problems of the crisis. Usually, histories of the problems at AIG focus on the company's Financial Products division and its infamous credit default swap business. As Anna Paulson and Robert McDonald described in a paper several years ago, however, another major contributor to AIG's troubles was the company's securities lending program.[4] In fact, despite the Financial Products' division's decision to stop writing mortgage-related CDS, other parts of the company doubled down on their exposure to mortgages.[5] As Paulson and McDonald explain, "During 2008, AIG's life insurance subsidiaries lost approximately $21 billion from securities lending, in which the life insurance subsidiaries loaned out assets and invested the proceeds in risky assets, including subprime RMBS and real-estate-backed CDOs."[6] Those losses were so severe that, absent the government bailout, a number of AIG's largest life insurance subsidiaries likely would have been insolvent.[7]

Narratives of AIG often suggest that the company was unregulated, but that is far from the case. The life insurance companies and their involvement in the securities lending program were regulated by multiple regulators, and AIG, as a whole, had many more regulators. AIG, in a way therefore, is the ultimate poster child for the financial crisis, which was not neatly attributable to one cause and clearly implicates both the private and the public sectors.

Poorly designed regulations had a role in bringing about the crisis. The favorable regulatory treatment given to highly rated securitization tranches is one example of a regulation that distorted risk-taking activity in the lead-up to the crisis.[8] Unlike one-off bad decisions by market participants, bad regulation has the effect of creating a common set of problems across the markets that can affect people and firms globally. The stakes are high when regulators get it wrong.

It is not always easy to identify in advance regulations that are poorly designed, as the flaws may not become apparent until thrown into the harsh light of a severe crisis. But I think we regulators owe it to the public to do the hard work of looking at our regulatory efforts with a skeptical eye to identify potential vulnerabilities and distortions created or encouraged by our rules.

I would urge all of us in this room, even as we continue implementing the G20 reforms, to exercise healthy skepticism, even with respect to key assumptions underlying those reforms. First, it is possible that the Pittsburgh reforms, even if perfectly implemented, would not have prevented the 2007-2009 financial crisis, and, in any event, we need to be realistic about the limits of those reforms. For example, the notion that the G20 reforms will usher in a world in which everything is centrally cleared is not realistic. Swaps like those at issue in AIG are not standardized and therefore are unlikely to be centrally cleared. Moreover, it is possible, even likely, that the G20 reforms leave unaddressed factors that were critical in producing the last crisis or those that are likely to create the next.

Second, central clearing is not a panacea; in fact, it brings with it its own risks. As Robert Steigerwald explains, "CCPs have not always been bulletproof in the past, and it will be challenging for them to insulate themselves effectively against inherently unpredictable market shocks in the future."[9] The ongoing discussions about clearinghouse recovery and resolution remind us how high the stakes are with so much being centrally cleared. Last month's member default at Nasdaq Clearing serves as another warning that managing clearinghouse risk is not an easy undertaking.[10] Nasdaq Clearing auctioned the defaulter's portfolio, but the defaulting member's collateral and default fund contribution were nevertheless overwhelmed by the losses and members had to make up the shortfall.[11] This default was a relatively simple one as defaults go. It involved a single, natural person member trading in

the Nordic and German power markets. We do not like thinking about—but must nevertheless think about—a more challenging default involving more and more interconnected members, larger portfolios, or more complicated products and occurring during a time of market stress.

Third, regulators labor under far more informational and decision-making limitations than we often like to admit. It is easy to forget our informational disadvantage to the markets in the wake of crises, when policymakers, often responding to political pressure, tend to want to wrest control away from the markets and place it into the hands of regulators. That reaction is understandable, but it reflects an unwarranted confidence in the ability of regulators. Indeed—no offense to any of the regulators in this room—regulators are inferior to markets in many ways. No matter how many resources regulators have, they cannot be in as many places as the eyes and ears of the market. Hayek correctly reminded us of the important role that individuals across society play in collecting, transmitting, and analyzing information.[12] When we displace the markets and the knowledge of the people working in them, we lose a crucial information source and an expert data analyzer. Good intentions, great intelligence, and intense work by regulators cannot change the fact that the markets have a distinct advantage.

Fourth, our errors in judgment often cause more problems than those of individual market participants. When regulators think they have a model right and force every regulated entity to use it, the consequences of getting it wrong are massive. If regulators or supervisors prescribe a flawed approach to risk management, assigning an inappropriate risk-weight, for example, to certain mortgage-related assets or sovereign debt, the consequences can be terrible and may come at the worst time. It is therefore incumbent upon us to be humble as we undertake the task of writing rules and overseeing firms' compliance with those rules. Setting forth broad principles and then permitting a diversity of approaches among firms, each exercising their own judgment, may actually reduce the likelihood of a future crisis.

Now I have to address the elephant in the room, or, more accurately, the elephant that has not been in the room. As you all know, my regulatory agency, the United States Securities and Exchange Commission, has not gotten its framework for security-based swaps up and running. Needless to say, we did not meet the G20's 2012 goal. I joined the SEC as a Commissioner in January, so I cannot give you insight into decisions about the agency's rulemaking agenda prior to that time, but the SEC does have approximately 100 good excuses. The SEC received almost 100 rulemaking mandates under the Dodd-Frank Act[13] and another set of mandates under the JOBS Act,[14] which sought to address some of the barriers faced by companies trying to raise capital in our private and public markets. In short, the SEC staff has been very busy in the years since the crisis.

SEC Chairman Jay Clayton, however, has made finishing the regulatory framework for security-based swaps a priority. Getting these rules in place sooner rather than later is important because, once they are in place, we need to allow firms appropriate amounts of time to come into compliance. By providing firms now with certainty about what the regulatory framework will look like, we can facilitate a smoother and quicker compliance process without additional undue delay in bringing these firms within a regulatory framework of the sort envisioned by the Pittsburgh principles.

To that end, I and my staff have been working with the Chairman, my colleagues on the Commission, and the staff on the many pieces of that framework. Just last week, we took an important step toward finalizing one of the unfinished pieces of the framework. We reopened the public comment period on our proposal on capital, margin, and segregation requirements for security-based swap dealers and major security-based swap participants.[15] We ask a number of questions designed to elicit comment—informed by regulatory and market developments since the original proposal was published—on all aspects of the proposals and ask specifically about potential modifications to the proposed rule text. I look forward to reviewing the comments and then, drawing from commenters' insights, moving expeditiously to adoption.

I would like to give you some sense of the SEC's road ahead beyond last week's first step. We already have adopted many of our security-based swap dealer rules and have finalized our security-based swap reporting rules. The Commission, however, has conditioned compliance with these rules on the finalization of three remaining security-based swap dealer rules: (1) rules establishing capital, margin, and segregation requirements for security-based swap dealers and major participants; (2) rules establishing recordkeeping and reporting requirements for these entities; and (3) Rule of Practice 194, which would establish a process that would allow a statutorily disqualified associated person to effect or be involved in effecting security-based swaps on behalf of the registered entity. Security-based swap dealers are not required to comply with these and other security-based swap dealer regulations until they are registered, which they are not yet required to be.

Under our current approach, the registration compliance date for dealers and major participants will be the later of the following three dates: (1) six months after the capital, margin, or segregation rules are published in the Federal

Register; (2) the compliance date for the books and records requirement; or (3) the compliance date for Rule 194. Security-based swap data reporting will be required the later of one month after the security-based swap dealer registration compliance date or six months after a security-based swap data repository is registered with the Commission. The Commission has not yet proposed any mandatory clearing or trading determinations for any security-based swaps.

As we proceed to finalize these rules and thereby stand up a regime that implements the Pittsburgh principles, as embodied in the Dodd-Frank Act, my own involvement in this process is guided by several themes. First, I believe we need to be open to reconsidering elements of our proposed or final requirements for the purpose of building a strong, solid, lasting regulatory framework. For example, in my view, to the extent that our rules may interfere with the ability of our registrants to do business with firms regulated by other domestic or foreign authorities, or may otherwise increase the risk of geographic market fragmentation, we will need to explore possible alternative approaches to implementing Congress's mandate.

Second, unless there are extenuating circumstances, the Commission should articulate clear rules and provide its own guidance rather than relying on subsequent staff no-action letters or other staff-level guidance to make the regime workable. I firmly believe that the Commission needs to grapple with hard questions, determine whether there is an appropriate policy response, and articulate that response through a transparent, Commission-level process. Thus, although the Chairman and I hope to work with the staff to bring the remaining Title VII issues before the Commission quickly, I want to ensure that our process is also careful and deliberate, that we listen closely to market participants and other interested parties, and that we get things as close to right as possible the first time around. I am also advocating that the Commission streamline its processes so that the Commission can respond more nimbly when implementation issues arise, as they will.

Third, we need to account for the challenges that market participants will face as they come into compliance with an entirely new, comprehensive, and extremely complicated regulatory regime. For example, it is likely that dealer registration is going to pose significant operational challenges and may require dealers to create new systems, establish new policies and procedures, and redirect human and capital resources. Some dealers may choose to re-evaluate their business structures. Of even greater concern to me is that dealers' counterparties are also going to have to contend with many of these challenges, even if they are not required to register as dealers under Title VII. We can mitigate these challenges by ensuring that the compliance periods for our rules provide the market with adequate time to prepare for and then comply with these requirements and working with our fellow regulators to ensure that multiple rulesets do not unduly burden market participants. We want to make sure that the companies that use these markets to manage their risks are able to do so seamlessly throughout the implementation period.

I hope that the SEC will quickly finalize the capital, margin, and segregation rules after the reopened comment period closes. I hope too that the finalization of the books and records requirements and Rule 194 release will come soon thereafter. Finalizing these three rules would start the clock ticking toward the date when dealers would be required to register.

At the same time, and in parallel with these key rules, I am interested in finding solutions to other important issues that may present obstacles to an efficient transition to Title VII regulation. Some of these involve rules that apply to firms that will be registered both with the SEC and the Commodity Futures Trading Commission (CFTC) or that are located in foreign jurisdictions. For example, I would like to see the Commission address questions around the ability of dealers to rely on representations made in connection with CFTC external business conduct requirements. Also ripe for resolution are issues surrounding the certification and opinion of counsel requirement that applies to foreign dealers, and the scope of our associated person definition and background check requirements, which may present compliance challenges to foreign dealers. I am also interested in exploring whether the Commission should consider possible alternative approaches to our so-called arrange-negotiate-and-execute requirements to reduce the possibility of market fragmentation.

Many of these latter issues involve joint work with our sister American regulator, the CFTC, or our international colleagues. Our staff has been hard at work in recent months working on harmonization with the CFTC. CFTC Chairman Chris Giancarlo, Chairman Clayton, and CFTC Commissioner Brian Quintenz, with whom I have been working directly, have evidenced a deep commitment to harmonizing our regulatory frameworks, even as they revisit the CFTC framework in light of a number of years of experience with its operation. The CFTC, after a long period of not having the five Commissioners it is supposed to have, is now back up to full strength, which I expect will aid the harmonization effort. Indeed, one of the new Commissioners worked with me in the Senate during the drafting of the Dodd-Frank Act[16] and the other was on the staff of the CFTC during the drafting and implementation of the law.[17]

Domestic coordination is only one piece of the coordination efforts we must undertake as we stand up our security-based swap regulations. We also must work with our international counterparts. We need to consider with care the extent to which our regulations reach outside the United States. The Commission has limited resources, and many of our fellow regulators have implemented regulatory frameworks designed to advance the policy goals set forth in Pittsburgh nine years ago. Thinking again about the dangers of over-homogenization, I believe that a lack of absolute uniformity of methods for achieving our shared goals can have a positive effect on the stability and resilience of our system. Moreover, regulatory efficiency and international comity counsel strongly for careful tailoring of the contours of our regulatory oversight. Only an integrated, mutually respectful approach will enable us to achieve our common goals. Where possible, we should avoid duplicating regulatory and supervisory efforts and reduce the attendant risk of fragmenting the market along territorial lines.

As a practical matter, then, I believe that the Commission's implementation of Title VII must allow for robust substituted compliance with broadly comparable foreign requirements. I also hope that we can begin engaging with all of you as soon as our relevant rules are finalized so that we can, where appropriate, make such determinations well before our registration compliance date. Even before our rules are in place, I am happy to start speaking with you about how substituted compliance might work.

Our work together to ensure that our regulatory systems complement one another without crowding each other out is important because it will ensure that the global over-the-counter derivatives market can serve the risk management needs of companies throughout our economies. Properly functioning risk transfer markets are a source of stability. A side benefit of regulatory cooperation of this sort and at this time is the deepening of our cross-border friendships. These relationships are invaluable during times of market stress when being able to count on the goodwill, insights, and availability of one's regulatory counterparts around the world inures to the benefit of all of us and the countries on behalf of which we work.

The Leaders' Statement from the Pittsburgh summit noted that the goal was "to turn the page on an era of irresponsibility and to adopt a set of policies, regulations and reforms to meet the needs of the 21st century global economy."[18] I do hope that we, as regulators, take this to heart. We have to be responsible in the way we regulate. We have to think about the potential unintended consequences of our actions. We have to assess periodically whether the rule changes we have made have solved the problems we set out to solve and whether, in the process of solving those problems, the new rules have given rise to a different set of problems. We have to remind ourselves and one another of the importance of working together to better regulate the financial system we share. Thank you for your time today. I look forward to our upcoming discussions.

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[1] G20 Leaders' Statement from The Pittsburgh Summit (Sept. 24–25, 2009), *available at* https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

[2] *Id*.

[3] *When Paper Paralyzed Wall Street: Remembering the 1960s Paperwork Crisis*, FINRA (Aug. 19, 2015), https://www.finra.org/investors/when-paper-paralyzed-wall-street-remembering-1960s-paperwork-crisis.

[4] Robert L. McDonald & Anna Paulson, *AIG in Hindsight* (Nat'l Bureau of Econ. Research, Working Paper No. 21108), *available at* https://www.nber.org/papers/w21108.

[5]*See, e.g.*, Congressional Oversight Panel, June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy 42 (June 10, 2010) ("AIG's aggressive expansion of its securities lending business, which is generally a low-risk and mundane financing operation on Wall Street, ramped up the company's exposure to the subprime mortgage market in late 2005. Ironically, this business's growth and investment strategy coincided with the time period that AIGFP stopped writing CDS on subprime-related CDOs."). *See also* Roddy Boyd, Fatal Risk: A Cautionary Tale of AIG's Corporate Suicide (2011) (providing an overview of the problems at AIG).

[6] McDonald & Paulson, *supra* note 4, at 9.

[7] *Id.* at 11-12. *See also* David Merkel, *To What Degree Were AIG's Operating Insurance Subsidiaries Sound? (2)*, The Aleph Blog (Apr. 29, 2009), https://alephblog.com/2009/04/29/to-what-degree-were-aig%E2%80%99s-operating-insurance-subsidiaries-sound-2/.

[8] *See, e.g.*, Stephen Matteo Miller, *The Recourse Rule, Regulatory Arbitrage, and the Financial Crisis*, 54 J. Reg. Econ., no. 2, Oct. 2018, at 195.

[9] Robert S. Steigerwald, Understanding Derivatives: Markets and Infrastructure Chapter 2: Central Counterparty Clearing (2013).

[10] Terje Solsvik and Lefteris Karagiannopoulos, *Nasdaq Restores Nordic Clearing Buffer After Power Default*, Reuters (Sept. 17, 2018), https://www.reuters.com/article/us-nordic-power-nasdaq/nasdaqs-nordic-clearing-buffer-almost-fully-restored-after-power-traders-default-idUSKCN1LX0WD.

[11] *Nasdaq Clearing: Latest Information About the Clearing Member Default, September 2018*, Nasdaq, https://business.nasdaq.com/updates-on-the-Nasdaq-Clearing-Member-Default/index.html ("Within 48 hours after the default, the portfolio was closed out through an auction according to Nasdaq Clearing's close-out procedures. However, the close out resulted in a loss for Nasdaq Clearing that exceeded the defaulting member's collateral and default fund contribution.").

[12] F.A. Hayek, *The Use of Knowledge in Society*, 35 The Am. Econ. Rev., no. 4, Sept. 1945, at 519, *available at* http://www.kysq.org/docs/Hayek_45.pdf ("[T]he knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.").

[13] Davis Polk & Wardwell LLP, Dodd-Frank Progress Report 4 (2016), *available at* https://www.davispolk.com/files/2016-dodd-frank-six-year-anniversary-report.pdf.

[14] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306.

[15] Press Release, U.S. Sec. and Exch. Comm'n, *SEC Reopens Comment Period for Capital, Margin, and Segregation Requirements for Security-Based Swap Participants* (Oct. 11, 2018), *available at* https://www.sec.gov/news/press-release/2018-233.

[16] *Commissioner Dawn DeBerry Stump*, U.S. Commodity Futures Trading Commission, https://www.cftc.gov/About/Commissioners/CommissionerDawnDeBerryStump/index.htm

[17] *Commissioner Dan M. Berkovitz*, U.S. Commodity Futures Trading Commission, https://www.cftc.gov/About/Commissioners/CommissionerDanMBerkovitz/index.htm

[18] G20 Leaders' Statement from The Pittsburgh Summit, *supra* note 1.