

"A 'New' New Era:" Prepared Remarks Before the International Swaps and Derivatives Association Annual Meeting



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Thank you for the kind introduction. It's good to be back with the International Swaps and Derivatives Association (ISDA) again.

As is customary, I'd like to note that I'm not speaking on behalf of my fellow Commissioners or the SEC staff.

Swaps emerged in the 1980s to provide producers and merchants with a way to lock in the price of commodities, interest rates, and currency rates. Our economy benefits from a well-functioning swaps market, as it's essential that companies have the ability to manage their risks.

When I first appeared before this group, as Chair of the Commodity Futures Trading Commission (CFTC), Washington was still developing the regulatory response to the 2008 financial crisis. At the time, I had the honor of working with then-CFTC Commissioner Scott O'Malia, now the CEO of ISDA, on reforms to the swaps market. A decade ago, I called it a "new era for the swaps marketplace." [\[1\]](#)

The financial crisis had many chapters, but a form of security-based swaps — credit default swaps, particularly those used in the mortgage market — played an important role throughout the story.

International banks were using credit default swaps to lower regulatory capital requirements and to hedge their bank loan portfolios — or so they thought.

These derivatives were at the core of what led to the \$180 billion bailout of AIG, whose near-failure accelerated the crisis.

More than a decade later, we've continued to see the relevance of this market. For instance, in light of Russia's invasion of Ukraine, many market participants are closely watching the credit default swaps related to Russian companies and sovereign debt.

The security-based swap market comprises also includes single-name and narrow-based equity swaps, some of which are called total return swaps.

Hedge funds and other asset managers increasingly have been using total return swaps to express a position that then may be held on the balance sheet of their prime broker or bank.

In March 2021, a month before I was sworn in as SEC Chair, Archegos Capital Management failed. Archegos used total return swaps based on large concentrated positions in underlying stocks, and prime brokers had significant exposure to that family office. In April, we charged Archegos Capital Management and affiliated individuals with committing fraud and manipulating stock prices using total return swaps.[\[2\]](#)

Ten years before the collapse of AIG, in 1998, Long-Term Capital Management failed. It brought with it more than \$1 trillion of derivatives contracts, many of which were total return swaps. I was serving at the U.S. Department of the Treasury at the time, sent along with the Federal Reserve to examine the impending failure of this firm.

Thus, the role of security based swaps in the market jitters in 1998, 2008, and 2021 help inform how I think about security-based swaps.

When Congress decided to bring reforms to the overall swaps market, they assigned the bulk of the swaps market to our sibling agency, the CFTC, which I had the honor of chairing. They assigned authority over security-based swaps, however, to the SEC, as these derivatives were related to the securities, issuers, and markets at the core of our remit.

Congress sought to align key aspects of the security-based swap market with our policy perimeter for other aspects of the securities markets: reducing risk, increasing transparency, and enhancing market integrity.

While we have adopted many reforms to the security-based swap market, we have work to do to further fulfill our obligations under Dodd-Frank and update rules for this marketplace. Thus, we are embarking on yet another “new era.”

Risk Reduction

The reforms included two main ways to reduce risk. First, dealers would have to register with the SEC. In doing so, they’d need to have key back-office controls and adequate cushions against losses.

Last year, in November, security-based swap dealers and major security-based swap participants were required to register with the Commission for the first time.

The requirements for the 47 conditionally registered security-based swap dealers include new counterparty protections, requirements for capital and margin, internal risk management, supervision and chief compliance officers, trade acknowledgement and confirmation, and recordkeeping and reporting procedures.[\[3\]](#)

The other part of Dodd-Frank’s risk-reduction regime was central clearing.

In 2016, we adopted new rules for clearinghouses. The SEC now regulates three clearinghouses that clear security-based swaps, in particular credit default swaps.

Transparency

Next, I’d like to discuss transparency. Under Dodd-Frank, Congress determined that the security-based swap markets would benefit from more transparency, both pre-trade and post-trade.

Pre-Trade Transparency

Congress determined that the platforms where swaps were traded could strengthen the pre-trade transparency of this market.

The SEC originally proposed rules for security-based swap execution facilities (security-based SEFs) in 2011. Subsequently, the CFTC was able to stand up a framework for its SEFs, a framework that experts have said has worked well over the past decade. In fact, Bank of England economists found that that regime saves end users millions of dollars per day.[\[4\]](#)

Thus, in April, the Commission proposed to create a framework for the registration of security-based SEFs that would harmonize with the SEF framework of the CFTC.[\[5\]](#)

We expect that the entities that will register as security-based SEFs also are registered as SEFs with the CFTC. This would facilitate efficiencies for market participants.

Post-Trade Transparency

With regard to post-trade transparency, the SEC has implemented two initiatives, and the Commission recently put out another proposal for comment.

First, in November, new rules related to reporting of security-based swap data went into effect. These rules require such transaction data to be reported to a security-based swap data depository, and thus be available to the SEC.

Second, beginning in February, the security-based swap data repositories were required to disseminate data about individual transactions to the public, including the key economic terms, price, and notional value.^[6] In April, there was about \$50 billion traded across about 16,000 trades in credit default swaps.^[7] In the early days of April, total return swaps accounted for about \$500 billion in volume across 70,000 trades per day.^[8] So it's a significant and sizable market!

Third, in December, the Commission proposed to require public reporting of large security-based swap positions. Congress provided this authority, under Exchange Act section 10B, in response to the lessons of the 2008 financial crisis.^[9] This position data is another step toward increasing transparency in this opaque market. The staff are currently working through comments from the public.^[10]

Altogether, I believe the increased transparency provided by these rule implementations and proposals would help alert the SEC and the public to cases in which individual funds have positions across multiple prime brokers or banks.

Market Integrity

Next, I'd like to turn to two proposals we made to enhance integrity of the security-based swap market.

First, in December, the Commission re-proposed new Exchange Act rule 9j-1 to prevent fraud, manipulation, and deception in connection with security-based swap transactions.

The rule is designed to take into account the unique features of a security-based swap. Namely, it would explicitly reach misconduct in connection with the ongoing payments and deliveries that typically occur throughout the lifecycle of these instruments. Thus, this rule is designed to guard against problematic behavior while protecting beneficial activity.

Second, in December we also proposed under section 15F of Dodd-Frank to prohibit the personnel of security-based swap dealers from unduly influencing their chief compliance officers. This gets to our mission to protect investors and safeguard market integrity.

Other Topics

Lastly, I'd like to raise two other topics before I close.

Crypto and Derivatives

One is on the intersection of crypto assets with derivatives.

The fact is, most crypto tokens involve a group of entrepreneurs raising money from the public in anticipation of profits — the hallmark of an investment contract or a security under our jurisdiction. Some, probably only a few, are like digital gold; thus, they might be like commodities. Even fewer, if any, are actually being used in general commerce for payments.

My predecessor Jay Clayton said it, and I will reiterate it: Without prejudging any one token, most crypto tokens are investment contracts under the Supreme Court's *Howey* Test.

Make no mistake: If a swap is based upon a crypto asset that is a security, then that is a security-based swap. Thus, our rules apply to them. Any offer or sale to retail participants must be registered under the Securities Act of 1933 and effected on a national securities exchange.

And furthermore, if platforms — whether in the decentralized or centralized finance space — offer security-based swaps, they are implicated by the securities laws and must work within our securities regime.

I know ISDA is working on a project to develop legal standards with respect to crypto derivatives.^[11] Such standardized approaches can be a good thing for markets. At the end of the day, though, I think it's important to recognize that if the underlying asset is a security, the derivative must comply with securities regulations.

We've brought some cases involving retail offerings of security-based swaps, including charges against Abra and a related company that conducted security-based swaps transactions over the blockchain;^[12] unfortunately, there may be more. We will continue to use all of the tools in our enforcement toolkit to ensure that investors are protected in cases like these.

Swaps and Complex Products

Finally, I want to touch upon the use of derivatives within structured and so-called complex products.

A lot of attention has been paid to bitcoin futures ETFs. That's just one kind of investment product that is based upon or wrapped around derivatives.

Market participants' use of derivatives touch so many parts of our markets, from SEC registered funds wrapping these products in publicly offered strategies, to numerous private funds using derivatives at significant exposure levels. Exchange-traded products (ETPs), exchange-traded funds (ETFs), and exchange-traded notes use strategies and structures that are more complex than typical stocks and bonds.

For example, some products might be so-called "leveraged" or "inverse" ETFs, or might be linked to a volatility index. ^[13] The use of derivatives can present unique and potentially significant risks to investors across market sectors.

These investment products, though, also can pose risks even to sophisticated investors, and can potentially create system-wide risks by operating in unanticipated ways when markets experience volatility or stress conditions.^[14]

In the past few months alone, with our regulatory and law enforcement partners, we have brought charges for historic events involving funds and derivatives against Archegos and Infinity Q.^[15] There may be more to come, unfortunately.

Such conduct, including alleged inappropriate valuations, fraud, or manipulative activity, reminds us that we must promote transparency-enhancing initiatives to lower risk and protect investors. When products are made available to the public, they must comply with requirements related to marketing, sales practices, ongoing valuations, and risk management.

I've asked our Division of Investment Management and Division of Examinations to take a renewed and focused look at the use of derivatives by registered investment companies so that they're compliant with our rules. In addition, the compliance date for an October 2020 rule regarding the use of derivatives comes later this year.^[16]

Though the listing and trading of complex products can be consistent with the federal securities laws,^[17] that doesn't mean they are right for every investor. I encourage all investors to consider these risks carefully before investing in these products.

Conclusion

In conclusion, I believe that we have the opportunity to reduce risk, increase transparency, and strengthen the integrity of the derivatives market.

I'd also like to thank ISDA and its members for offering comments on our proposals. Staff carefully reviews the feedback we receive, and we greatly appreciate the time and care you put into your comments.

On occasion, security-based swaps have moved from the corners of the market to front and center. Various market events over the decades — from Long-Term Capital Management in 1998 to AIG in 2008 to Archegos in 2021 — remind us of that. I think it's important to shine light on these markets before any future such tremors arise. Thank you.

- [1] See Gary Gensler, “The New Era of Swaps Reform” (Oct. 10, 2012), *available at* <https://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-124>.
- [2] See “SEC Charges Archegos and its Founder with Massive Market Manipulation Scheme,” *available at* <https://www.sec.gov/news/press-release/2022-70>.
- [3] See “List of Registered Security-Based Swap Dealers and Major Security-Based Swap Participants,” *available at* <https://www.sec.gov/tm/List-of-SBS-Dealers-and-Major-SBS-Participants>. As of May 9, 2022, there are 47 conditionally registered security-based swap dealers and no major security-based swap participants.
- [4] See Evangelos Benos, Richard G. Payne, and Michalis Vasios, “Centralized Trading, Transparency and Interest Rate Swap Market Liquidity: Evidence from the Implementation of the Dodd-Frank Act” (Journal of Financial and Quantitative Analysis, Vol. 55, No. 1, Feb. 2020, p. 159-192).
- [5] See Gary Gensler, “Statement on Registration of Security-Based Swap Execution Facilities” (April 6, 2022), *available at* <https://www.sec.gov/news/statement/gensler-registration-sbs-20220406>.
- [6] See Gary Gensler, “Statement on Public Dissemination of Security-Based Swap Transactions” (Feb. 16, 2022), *available at* <https://www.sec.gov/news/statement/gensler-public-dissemination-sbs-transactions-202202>.
- [7] See Chris Barnes, Clarus Financial Technology, “Most Actives in CDS Trading” (May 4, 2022), *available at* <https://www.clarusft.com/most-actives-in-cds-trading/>.
- [8] See Amir Khwaja, Clarus Financial Technology, “SBSDR – A Look at Equity Total Return Swaps” (April 12, 2022), *available at* <https://www.clarusft.com/most-actives-in-cds-trading/>.
- [9] See Gary Gensler, “Statement on Exchange Act 10B and Rule 9j-1” (Dec. 15, 2021), *available at* <https://www.sec.gov/news/statement/gensler-10b-rule-9j-1-20211215>.
- [10] Relatedly, in February, the Commission proposed to shorten the deadlines by which beneficial owners of a company — those who own at least 5 percent of the company — have to inform the public and other investors of their position. The proposal would clarify when and how certain derivatives acquired with control intent count towards the 5 percent threshold for reporting. See Gary Gensler, “Statement on Beneficial Ownership Proposal” (Feb. 10, 2022), *available at* <https://www.sec.gov/news/statement/gensler-statement-beneficial-ownership-proposal-021022>.
- [11] See Scott O’Malia, “Developing Contractual Standards for Crypto Derivatives” (Jan. 18, 2022), *available at* <https://www.isda.org/2022/01/18/developing-contractual-standards-for-crypto-derivatives/>.
- [12] See “SEC Charges App Developer for Unregistered Security-Based Swap Transactions” (July 13, 2020), *available at* <https://www.sec.gov/news/press-release/2020-153>.
- [13] See Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors, Office of Investor Education and Advocacy (Aug. 1, 2009), *available at* <https://www.sec.gov/investor/pubs/leveragedetfs-alert.htm>. This statement, like all staff statements, has no legal force or effect; it does not alter or amend applicable law, and it creates no new or additional obligations for any person. Exchange-traded funds that seek to provide the multiple of a performance of a benchmark across a single day are commonly referred to as “leveraged ETFs,” while funds that seek to provide the opposite performance of a benchmark are commonly referred to as “inverse ETFs.”
- [14] For example, the SEC’s Asset Management Advisory Committee noted that while “ETPs generally performed as designed” during volatility associated with COVID-19, “[c]ertain ETPs, particularly those offering inverse or leveraged exposures, experienced conditions that industry participants might have found hard to predict, such as triggering provisions that resulted in product liquidation.” The Committee made six recommendations to the SEC and FINRA designed to improve the ETP ecosystem. Preliminary Recommendations of ETP Panel Regarding COVID-19 Volatility: Exchange-Traded Products, Asset Management Advisory Committee (Sept. 16, 2020), *available at* <https://www.sec.gov/files/prelim-recommendations-to-amac-on-etps.pdf>. Additionally, during the February 5, 2018, market event known as

“Volmageddon,” the VIX futures market experienced a rapid increase in price and corresponding increase in demand. During this period, several VIX-related ETPs that held VIX futures attempted to execute their daily rebalance activity; due to their size, the Investors in many of these ETPs suffered significant losses. See The Day The VIX Doubled: Tales of “Volmageddon,” Luke Kawa, Bloomberg (Feb. 6, 2019), *available at* <https://www.bloomberg.com/news/articles/2019-02-06/the-day-the-vix-doubled-tales-of-volmageddon>

[15] See “SEC Charges Infinity Q Founder with Orchestrating Massive Valuation Fraud” (Feb. 17, 2022), *available at* <https://www.sec.gov/news/press-release/2022-29>.

[16] The rule applies to most registered investment companies (mutual funds but not money market funds, exchange-traded funds, registered closed-end funds, and business development corporations). See Release No. IC-34084, Use of Derivatives by Registered Investment Companies and Business Development Companies” (Oct. 2020), *available at* <https://www.sec.gov/rules/final/2020/ic-34084.pdf>.

[17] See, e.g., Order Setting Aside Action by Delegated Authority and Approving a Proposed Rule Change, as Modified by Amendment Nos. 2 and 4, to List and Trade Shares of the 2x Long VIX Futures ETF Under BZX Rule 14.11(f)(4) (Trust Issued Receipts), Release No. 34-93299 (October 1, 2021), *available at* <https://www.sec.gov/rules/sro/cboebzx/2021/34-93229.pdf>; Order Setting Aside Action by Delegated Authority and Approving a Proposed Rule Change, as Modified by Amendment Nos. 1 and 3, to List and Trade Shares of the -1x Short VIX Futures ETF Under BZX Rule 14.11(f)(4) (Trust Issued Receipts), Release No. 34-93230 (October 1, 2021), *available at* <https://www.sec.gov/rules/sro/cboebzx/2021/34-93229.pdf>.