Speech

Prepared Remarks of Gary Gensler, Chair of the Securities and Exchange Commission, Before the American Bar Association Derivatives and Futures Law Committee Virtual Mid-Year Program

Chair Gary Gensler

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Thank you for the kind introduction. It's good to be back with the American Bar Association's Derivatives and Futures Law Committee.

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

When I first appeared before this committee more than a decade ago, Washington was still developing the regulatory response to the 2008 financial crisis.

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

International banks were using credit default swaps to hedge their bank loan portfolios — or so they thought.

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

Reliance on those same credit default swaps allowed many banks to lower regulatory capital requirements to dangerously low levels.

CDS also contributed to weak underwriting standards, particularly for asset securitizations. Investors and Wall Street allowed them to stand in for prudent credit analysis.

At the end of 2007, the CDS market had notional value of $61 trillion[1] — more than 10 times larger than it had been in 2004.[2]

Though it's a smaller market these days, credit default swaps still play an important role. The notional value of credit default swaps is more than $8 trillion.[3]

Further, the security-based swaps market involves more than just the credit default swaps that were at the center of the 2008 crisis. It also comprises single-name and narrow-based equity swaps, some of which are labeled total return swaps.

Though we don't yet have reliable data on the size of equity swaps and total return swaps, from time to time they too have played an important role in our capital markets.

When Congress decided to bring reforms to the overall swaps market, they assigned authority over security-based swaps to the SEC. They assigned the bulk of the swaps market —including interest-rate, energy, agricultural, and other commodity-based swaps — to our sister agency, the Commodity Futures Trading Commission, which I had the honor of chairing at the time.

In these reforms, Congress sought to address two main issues in this previously unregulated market: reducing risk and increasing transparency.

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, through both their capital levels and customer margin.

This year, the SEC is implementing rules related to some of those authorities mandated by Congress 11 years ago.

To that end, security-based swap dealers and major security-based swap participants will begin registering with the Commission by Nov. 1. We expect that 45 to 50 entities will register as security-based swap dealers — some of which will be from the same family of firms.

The registration requirements 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. These areas are focused on reducing risk in our markets.

Further, given the global nature of the security-based swaps market, international dealers have asked the SEC for the ability to comply with rules from their home jurisdictions, while still meeting U.S. regulations.

There's a process that the Commission established several years ago by which we consider whether to grant this substituted compliance to dealers. For the Commission to grant substituted compliance, dealers' home jurisdictions must have comparable rules of the road to ours in the U.S. and effectively supervise and enforce those rules.

To grant substituted compliance, we must ensure that those other regimes indeed produce comparable outcomes to the SEC's own regulations. We don't want dealers to be incentivized to move among jurisdictions so they can take advantage of regulatory arbitrage.

For the last 18 months, the agency has engaged with a number of foreign authorities and security-based swap dealers in consideration of substituted compliance.

The Commission has finalized a substituted compliance determination order with respect to key back-office controls for German firms with a prudential regulator. We expect to receive additional applications for substituted compliance from foreign jurisdictions soon.

One of the features of the SEC's application process is that completed applications for substituted compliance are also published for notice and comment, and we value the input of commenters into this process. The Commission has noticed applications for the UK and France.

Given the coordination with applicants and foreign authorities, evaluating these substituted compliance applications is a significant undertaking. For example, our substituted compliance regime requires, for jurisdictions where substituted compliance is granted, that there be a supervisory and enforcement memorandum of understanding or other arrangement in place to facilitate information-sharing between the SEC and the relevant foreign authorities. In light of that, SEC staff are working to finalize recommendations to the Commission for substituted compliance determination orders and for the Commission to enter into MoUs expeditiously.

The other part of Dodd-Frank's risk-reduction regime is through central clearing.

In 2016, we adopted new rules for clearinghouses. The SEC regulates three clearinghouses that voluntarily clear security-based swaps: ICE Clear Credit, ICE Clear Europe, and LCH SA.

Next, I'd like to discuss transparency. Congress determined that the security-based swap markets would benefit from more transparency, promoting efficiency of markets and lowering risks.

Post-trade, this would mean the public could see the price and volume of transactions. Pre-trade, this would mean that buyers and sellers could meet on a trading platform with transparent prices.

In 2015 and 2016, the SEC completed rules related to post-trade transparency. On Nov. 8, these new rules will go into effect, requiring these transaction data to be reported to a swap data depository, and thus available to the SEC and, under appropriate circumstances, other regulators.

Then, beginning on Feb. 14, 2022, the swap data repositories will be required to disseminate data about individual transactions to the public, including the key economic terms, price, and notional value.

Together, this information will greatly enhance post-trade transparency on a transaction-by-transaction basis.

Further, to allow the Commission and the public to see aggregate positions, Congress under Exchange Act section 10B gave us authority to mandate disclosure for positions in security-based swaps and related securities. I've asked staff to think about potential rules for the Commission's consideration under this authority.

As the March collapse of the family office Archegos Capital Management showed, this may be an important reform to consider.

At the core of that story was Archegos' use of total return swaps based on underlying stocks and significant exposure that the prime brokers had to the family office.

The limited transparency in this market, combined with potential shortcomings in market participants' risk management, contributed to firms' taking overly large positions and to subsequent system-wide tremors when firms started to unwind those positions.

I believe additional public disclosure of that fund's positions, as well as public dissemination of individual transactions in total return swaps, may have helped.

This wasn't the first time that one fund's use of total return swaps had far-reaching implications for the capital markets, as the 1998 collapse of Long-Term Capital Management showed.[4]

In addition, the Commission has yet to finish the rules for the registration and regulation of security-based swap execution facilities (SEFs).

Back in 2011, the SEC proposed rules for security-based SEFs. I've asked staff to recommend how we can best harmonize security-based SEFs rules with those that have been in place under the CFTC for nine years and have been effective. To accomplish this, I would envision that we would put out another notice-and-comment rulemaking.

I believe aligning the SEC's regime with the CFTC's could garner many of the same benefits — bringing together buyers and sellers with transparent, pre-trade pricing and lowering risk in the marketplace.

This approach also could limit additional costs on security-based SEFs and their market participants because many of them already are subject to the CFTC's rules.

Together, the rules going live this fall will increase transparency and reduce risk in the derivatives market. I believe they're long overdue.

Various market events over the decades — from Long-Term Capital Management in 1998 to AIG in 2008 to Archegos in 2021 — remind us that we need to consider using all of our authority if we are to meet our obligations under the Dodd-Frank Act.

Thus, I've asked staff to consider ways we can continue to increase transparency and reduce risk through our unused authorities, particularly with regard to security-based SEFs and position reporting. I've also asked staff to make recommendations on proposed rules for the Commission's consideration on the anti-fraud and anti-manipulation mandate from Dodd-Frank, as now included in Section 9(j) of the Exchange Act.

Before I conclude, I'd briefly like to discuss the intersection of security-based swaps and financial technology, including with respect to crypto assets. There are initiatives by a number of platforms to offer crypto tokens or other products that are priced off of the value of securities and operate like derivatives.

Make no mistake: It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities. These platforms — whether in the decentralized or centralized finance space — are implicated by the securities laws and must work within our securities regime.

If these products are security-based swaps, the other rules I've mentioned earlier, such as the trade reporting rules, will apply to them. Then, any offer or sale to retail participants must be registered under the Securities Act of 1933 and effected on a national securities exchange.

We've brought some cases involving retail offerings of security-based swaps; 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.

Thank you again for having me today, and I look forward to answering your questions.

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[1] *See* Bank for International Settlements, "The credit default swap market: what a difference a decade makes" (June 2018), *available at* https://www.bis.org/publ/qtrpdf/r_qt1806b.htm.

[2] *See* CFA Institute, "Credit Default Swaps and the Credit Crisis (Digest Summary)," *available at* https://www.cfainstitute.org/en/research/cfa-digest/2010/05/credit-default-swaps-and-the-credit-crisis-digest-summary.

[3] *See* BIS Statistics Explorer, "Credit default swaps, by type of position," *available at* https://stats.bis.org/statx/srs/table/d10.1?f=pdf. Cited number refers to notional amounts outstanding for the second half of 2020.

[4] *See* "Treasury Under Secretary Gary Gensler Testimony Before the House Committee on Banking and Financial Services" (May 6, 1999), *available at* https://www.treasury.gov/press-center/press-releases/Pages/rr3137.aspx.