Testimony on Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

By

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Before the United States Senate Committee on Agriculture, Nutrition & Forestry

March 3, 2011

Chairman Stabenow, Ranking Member Roberts, and members of the Committee:

My name is Steven Bunkin and I am a Managing Director and Associate General Counsel at Goldman, Sachs & Co. Thank you for inviting me to testify at today's hearing.

OTC Derivatives and the Dodd-Frank Act

The over-the-counter ("OTC") derivatives markets play an essential role in capital markets and in the economy generally. These instruments are used by a range of entities, including corporate end-users and investment funds, as risk management and investment tools.

The Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank") imposes fundamental reforms on the financial markets. In debating Title VII of Dodd-Frank, Congress considered the possibility of requiring that all derivatives be traded on exchanges and centrally cleared. Congress recognized the importance of OTC products and determined that they should continue to be available to the broad range of market participants that use them.

Goldman Sachs has supported many of the policies reflected in Title VII. For several years, we and other members of the industry have worked with regulators to improve the infrastructure for these markets and to develop clearing of various products.

Since the enactment of Dodd-Frank, the regulators have worked with great dedication to develop the rule proposals contemplated by the Act. We appreciate the remarkable efforts that the staffs and Commissioners of the Commodity Futures Trading Commission and Securities and Exchange Commission (the "CFTC" and "SEC", respectively and, together, the "Commissions") have made to implement Title VII. It is critically important that the implementation of these complicated reforms be done in a manner that avoids disruptions and allows continuing access to OTC derivative instruments, and we are confident that this Committee agrees. To protect market liquidity, the rules must be developed with great care.

With that in mind, we offer the following recommendations to support the Committee in the discharge of its Title VII oversight responsibilities:

- We recommend that Title VII regulations be implemented in a deliberate, informed and sequenced manner;

- We request that market participants, particularly end-users, be given the opportunity to review and comment on the totality of the rule set before it is implemented, as well as the time to adjust their activities to achieve efficient and effective compliance with new requirements;
- We recommend the regulators study the effect on market liquidity of the proposed rules, adjusting them as appropriate; and
- We recommend that the CFTC revise its proposed business conduct rules to, among other things, ensure that swaps remain accessible to pensions, endowments and governmental entities who rely on them to conduct their activities.

We detail our specific recommendations below.

Phased In Implementation

It is essential that the Commissions phase in the Title VII in a manner that promotes the stability of the financial system. We propose a three-phase process to achieve this:

- In Phase I, create swap data repositories ("SDRs") and impose requirements on market participants to provide transactional information to them.
- In Phase II, impose clearing requirements.
- In Phase III, after successfully completing the first two phases, regulators and market participants will have the tools and information necessary to create effective public trade-reporting mechanisms and swap execution facilities ("SEFs").

Having SDRs established early will allow the regulators to collect the information they need to develop other rules, such as the definition of "block transactions" and appropriate position limits based on actual market information. In addition, the regulators will benefit from having data that will allow them to monitor systemic risk. Other requirements, such as the business conduct standards would be implemented during the course of the three phases.

The foregoing approach is necessary in light of the scope of the Title VII reforms. Dodd-Frank represents the most comprehensive reordering of markets since the Securities Act of 1933 and the Securities Exchange Act of 1934. To implement Title VII it will be necessary to create new structures and substantially revise existing ones. Fundamental issues with respect to how participants will access the markets remain unresolved. SDRs, clearinghouses, SEFs, and market participants themselves will all need to build or supplement systems, and develop, negotiate and implement various agreements to comply with new requirements. The system enhancements necessary for clearinghouses simply to handle broader participation presents a great challenge.

Market participants will need to make a number of strategic decisions about how to conduct activities to comply with the new rules. To do so, they will need resolution on a number of key questions that remain unanswered. These include issues as basic as which transactions will constitute "swaps" and what the impact of the Title VII requirements will be on activities conducted outside the United States. Providing businesses that are subject to new requirements with clarity on rules before they are imposed is both sound policy and essential to satisfy the requirements of the Administrative Procedures Act.

The Dodd-Frank rules should be considered in the context of existing regulation applicable to key participants, such as capital and prudential requirements. To avoid overlapping or inconsistent rules, the agencies will need to leverage these well-developed rules. Of course, Title VII rules will inter-relate with standards currently being developed at a more measured pace in Europe and elsewhere. Imposing Dodd-Frank rules before other international standards have been established will create the potential for regulatory arbitrage and a migration of liquidity to non-US markets.

We appreciate the willingness of the agencies to discuss with industry participants the important question of implementation and look forward to continuing to work with the regulators on these issues.

Market Evolution

We believe that as a result of the fundamental reforms mandated by Title VII the OTC derivatives markets will evolve in significant ways, the specific characteristics of which are difficult to predict at this point. Our firm has had the opportunity to observe and participate in a variety of market structure developments, including those resulting from

- The advent of the euro,
- Decimalization in equities, and
- The implementation of the TRACE reporting system in bond markets.

Our experience suggests that it is difficult to predict the manner in which changes will occur, and that evolution should be encouraged so that the market finds a new equilibrium. We recommend that the regulators adopt an approach that creates a robust foundation and framework for the new market structure, and fosters an environment in which the market naturally evolves.

Transparency/Liquidity

We recommend that the Commissions evaluate certain proposed rules in light of the Congressional intent to promote liquidity and preserve access to OTC derivatives. Liquidity is essential for the proper operation of capital markets. Liquidity enables a market participant to transfer risk or establish an investment position efficiently and promotes confidence in markets. Correspondingly, the absence of liquidity, particularly during times of market stress, exacerbates systemic risk. The proposed rules relating to execution of swaps on SEFs and real-time public reporting of transactions raise concerns with respect to liquidity and the ability of market participants to choose how they will transfer risk or establish an investment position.

SEFs are a key component of ensuring that OTC derivatives continue to remain available and liquid in the post-Dodd-Frank world. In drafting the definition of and provisions applicable to SEFs, Congress took care to ensure that the standards governing SEFs would be distinct from those governing exchanges by providing greater flexibility in the manner of execution.

The market broadly expected that systems that provide a “request for quote” or “RFQ” functionality would be the principal means through which parties would be able to satisfy the Title VII execution requirement while having flexibility in execution. However, the CFTC SEF proposal requires participants to broadcast solicitations to at least five quoting parties. This is significantly more quoting parties than clients currently choose to solicit in the existing market structure. This

requirement will hurt many investors by forcing them to reveal their expected positions more widely than necessary in order to find the best price. It also appears to go beyond the standard set out in Title VII, which simply requires that multiple participants "have the ability to execute swaps by accepting bids/offers made available by multiple participants." The SEF rule proposed by the SEC more closely adheres to the statutory text by requiring SEFs to afford market participants the ability to request quotes from all members of the SEF while allowing the requesting party to solicit a quote from as few as one participant. We strongly encourage the CFTC to adopt a consistent approach.

With respect to "real-time" reporting, Title VII provides a means to calibrate transparency objectives against liquidity considerations. The lever for achieving this calibration is the block transaction definition. A "block" trade is one of a size larger than that customarily transacted in the relevant market. Transactions that qualify as blocks are eligible for an alternative reporting cycle to protect liquidity.[1] We believe that the CFTC proposal on the block transaction definition will fail to capture many trades that should qualify to serve the purpose of the definition.

Specifically, under the proposal trades will qualify as blocks only if they are of a size that is larger than the greater of (a) the top five percent of trades in a particular category or (b) five times the highest of the mean, median or mode of trades of the relevant category during the preceding year. Moreover, the reporting period afforded to trades that do qualify as blocks, 15 minutes in most cases, lacks an analytical foundation and is unlikely to be sufficient for the intended purpose. Unfortunately, the CFTC is not in a position to know whether the reporting period or the metrics for determining a block trade are an appropriate means for satisfying the purposes of the statute because the Commission does not yet have the market data that would be needed to make these determinations based on actual market dynamics. In analyzing the proposed rule, we applied the block metrics to our own positions and found these tests would make block treatment available on an extremely limited basis for many products, constraining the liquidity that would be available to investors.

Business Conduct Standards

We strongly support promoting integrity in the market and in dealings involving swap dealers or major swap participants and their clients. We are concerned, however, that the CFTC's proposed business conduct standards go beyond the Dodd-Frank mandate in ways that are both inconsistent with the nature of the counterparty relationship in a derivative transaction and that create uncertainty for market participants while providing little appreciable benefit. In particular, the proposed business conduct rules would impose a host of duties on dealers that do not have a basis in Title VII, including for example, the requirement to use reasonable due diligence to obtain facts necessary to "effectively service the counterparty" or "implement any special instructions" from the counterparty. Such vague, extra-contractual duties may cause dealers to retreat from providing swaps in a variety of situations. Another example of the breadth of the proposed rules is the provision that would transform breaches of bi-lateral confidentiality agreements into federal offenses.

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[1] In addition, block trades may be executed bi-laterally even if otherwise subject to an execution requirement.

The provisions applicable to transactions involving pensions, endowments and certain governmental entities (referred to as "special entities") present particular concerns. The special entity provisions impose what is tantamount to a fiduciary duty in situations when dealers/MSPs provide information specific to transactions. This fiduciary-like standard may apply in a number of situations because other provisions of the rules require dealers/MSPs to provide transaction specific information to counterparties. Congress specifically decided to eliminate a fiduciary standard from draft legislation to continue to allow special entities to access risk management and investment products; it recognized that the role of a fiduciary is not compatible with that of a counterparty and may, under certain laws, be illegal.

Position Limits

The Commission's proposed rule on position limits for listed and OTC commodity contracts merits this Committee's focus.

Dodd-Frank directs the Commission to adopt specific position limits to the extent that such limits are appropriate to address excessive speculation. In its rule, however, the Commission proposes to impose limits "prophylactically" without finding that such limits are appropriate. The Commission has taken this approach notwithstanding the fact that its staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets or that position limits will prevent excessive speculation.

But even beyond whether such limits are appropriate, we are particularly concerned about the specific content of the proposed rule. In this regard we note that to the extent limits are appropriate, Dodd-Frank directs the Commission to establish them in accordance with a four-part mandate:

- Preventing excessive speculation,
- Preventing manipulation,
- Preserving liquidity for hedging, and
- Protecting the price discovery function.

In our view, the CFTC proposed rule addresses an objective not contained in this mandate: position concentration. Under the proposed rule, position concentration is deemed to exist when an entity has a large holding of a particular contract, even if that holding is non-speculative by virtue of it being a hedge or an offset for other positions. Under the proposed rule, an intermediary would not be permitted to offset positions in different contract types (e.g., swaps vs. futures) on the same or similar underlying commodity for purposes of determining limit compliance even though the two positions are, because of their offsetting nature, manifestly not speculative.

For example, assume a dealer sold a fuel swap to an airline and then bought futures on the same product. Those transactions, viewed together, are not speculative and, therefore, should be eligible to be considered against the applicable limit on a netted basis. However, CFTC rule would still apply separate contract specific limits (i.e., a limit on fuel swaps and a limit on fuel futures). In addition to not being contemplated by the Title VII mandate, it actually undermines the ability of dealers to provide liquidity to hedgers, which is something that is specifically part of that mandate.

As a financial intermediary, Goldman Sachs has a deep interest in the stability, transparency and efficiency of the OTC derivatives markets. We believe that balance in the implementation of Title VII of the Dodd-Frank Act is vital -- liquidity and transparency are both equally important and we committed to working with Congress, the regulators, industry participants and, of course, our clients to achieve a successful and effective transition to reforms that promote greater market stability, healthy competition and prudent risk management.

I appreciate the opportunity to testify before this Committee and look forward to responding to any questions you may have.