



Testimony of Chris Concannon  
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Thank you Chairman Peterson and Ranking Member Lucas for the invitation to speak to you this morning regarding your legislation, the Derivatives Markets Transparency and Accountability Act of 2009.

Some of you may be wondering why NASDAQ OMX, the operator of the world's largest cash equities exchange, is testifying regarding OTC derivatives. Well, NASDAQ OMX owns and operates 17 markets and 8 clearing houses around the globe. Our markets trade equities, derivatives and fixed income products. Not only do we pride ourselves in operating our markets efficiently, but we are exceptionally proud of the efficiencies that we have delivered to these markets. In regards to OTC derivatives, I will admit that we have self interest in the reform of these markets. But this self interest is the product of almost four decades of experience in delivering efficiency and transparency to the financial markets.

When we examine your legislation we see a policy initiative that will bring fundamental change to a market that is defined by counterparty risk, unknown systemic risk and opaque markets. While we continue to deal with the worst financial crisis since World War II, we can't simply wait for it to end before we study and implement needed reforms. Reforms can and should be implemented now.

As your legislation recognizes, over the past several years and throughout the economy, trillions of dollars in investment instruments have been crafted through an unregulated web of interconnected, counterparty relationships. Even after all the billions in Federal subsidies, the books of banks and businesses are littered with these complex instruments whose value is opaque and potentially mispriced. These particular credit instruments continue to be traded in what's known as the over-the-counter or OTC market. Because these instruments are not valued in a transparent, efficient market with the opportunity for centralized clearing, unrecognized risk continues to be piled upon unrecognized risk.

The shortcomings of the over-the-counter market have been documented well by the hearings of this committee. There is no need to further expand on those findings. It is now time to implement change both by government action and by the markets themselves.

The markets and clearing houses that sit before you today are here to explain how our markets worked throughout this horrible crisis. Very few people can sit before Congress today and explain how their systems discovered prices everyday; how their clearing houses absorbed the impact of major defaults such as Lehman; or how they were able to settle each and every trade. We represent the markets that worked while the OTC markets represent the opaque market that tied these unsuspecting victims into a complex

web of financial disaster. The point is - centralized clearing worked as designed and it worked in many asset classes around the globe.

We at NASDAQ are confident of the beneficial effects of centralized clearing, transparency and regulation for the OTC markets. NASDAQ made its name by being a pioneer in the over-the-counter cash equities market. Until NASDAQ came on the scene, the cash equities market also once operated similar to the current OTC derivatives market.

NASDAQ was born out of a need to share information about stock trading in a central fashion, accessible to all, with a system designed to protect investors and facilitate discovery of the right price for each stock. We continue to operate on a simple principle that is the foundation of all markets: An informed and willing buyer and an informed and willing seller agreeing to trade is the best valid price discovery mechanism.

It is possible to transform an over-the-counter market to one that is centrally cleared and visible to all. We have done it; when NASDAQ was founded 37 years ago our primary mission was to bring order, discipline and fairness to the over-the-counter equities market. What we know from our experience is simple, yet revolutionary for this market: These OTC instruments need to be centrally cleared to better distribute or mutualize the risk. Central clearing fundamentally means more parties are backing a transaction versus one or just a few. Centralized clearing gathers strength from more parties while delivering capital efficiency through the benefits of netting multiple risk exposures.

Building on the decades of experience, NASDAQ OMX is bringing the values of organized markets including central clearing, standardized margin, transparency, and real valuations to what the Bank for International Settlements estimates is a \$458 trillion dollar over-the-counter interest rate swap market. While there has been much discussion about the credit default swap market, you should be aware that the interest rate swap market is six times larger than the credit default swap market.

As you may know, NASDAQ OMX recently became the majority owner of the International Derivatives Clearing Group (IDCG). IDCG, an independently operated subsidiary of The NASDAQ OMX Group, has developed an integrated derivatives trading and clearing platform. IDCG is transforming the interest rate swap marketplace, allowing members to convert their OTC swaps into a cleared future product with the full benefits of central clearing. This CFTC approved platform will provide an efficient and transparent venue to trade, clear and settle interest rate swap (IRS) futures.

One of the most compelling attributes of our IDCG endeavor is that it allows for all forms of execution. We have the ability to allow customers the flexibility to operate their business as they have, but with an independent and standardized view of the risk. This independence is the absolute core of a centrally cleared market place. By concentrating its focus on risk, IDCG can be open to multiple forms of execution. This flexibility allows for more of the market to participate in an open and consistent manner while all of the risk is marked-to-market by the same benchmark.

I must commend the Commodity Futures Trading Commission (CFTC) for its thorough review coupled with professional timeliness in approving the application for IDCG to

operate. With CFTC approval of IDCG's Derivatives Clearing Organization (DCO) license on December 22, 2008, IDCG is "live" today; operating a highly efficient market to clear and settle US dollar denominated interest rate swap futures. We, along with IDCG, look forward to the day when vast parts of the over-the-counter market are no longer stored in the back-rooms of brokerage houses but are held in well-capitalized clearing houses transparent to all – including the regulators and public policymakers.

Thus, NASDAQ OMX is highly supportive of provisions in Section 13 of your legislation that would protect our financial system and investors by requiring most OTC derivatives be settled and cleared. We believe this section is good public policy and hope to see it enacted into law. In addition, we support the ability of the CFTC to set some limited exemptions for derivatives that may contain complex contractual aspects rendering them inappropriate for clearing.

Let me offer one benefit of clearing in the interest rate swap space that will have an immediate and direct positive impact on the banking system. Current regulatory capital treatment for derivatives held by banks and other financial institutions applies a higher capital charge for bilateral, uncleared, holdings. If existing banks cleared their interest rate swap transactions through a central clearing house, significant capital would be released for the banks to apply to new lending or against other assets. Simply, under the current accounting rules, insolvency laws and international treaties (such as BASEL I & II), the current method of bilateral trading is not only less efficient - it is a more expensive use of capital.

We believe the entire financial system would benefit from a capital infusion as a result of mandating centralized clearing. To put it as succinctly as I can, centralized clearing reduces the market, counterparty, and operational risk of a portfolio. In addition, it can also reduce capital requirements that today, unfortunately, are often being supplied with non-performing taxpayer money.

Capital efficiency is greatly enhanced in conjunction with another benefit of central clearing: the process of netting. With central clearing, financial institutions can "net" out their positions across the entire market and further reduce their required capital reserves while at the same time reducing the complexities and risk of the bilateral world.

We also support efforts by the Federal Reserve, the FDIC and the Office of the Comptroller to evaluate the need for enhanced regulatory capital charges for non-cleared OTC transactions. We, at NASDAQ, believe it is critical that all forms of risk are appropriately priced, and that regulatory capital rules provide meaningful incentives to drive OTC derivatives on to central clearing houses.

We think that customers that use these derivatives should also demand that their transactions be subjected to clearing. According to a recent Bloomberg story, several State Attorney General's are investigating the opaque fees several local governments paid to obtain interest rate and other derivatives to hedge swings in borrowing costs for schools, states and cities – fees which were more difficult to challenge when neither information about execution pricing nor pricing of risk were publicly available.. Certainly, if state and local governments adopted the mandate to only transact cleared

products, the trend for clearing would be enhanced. The Bloomberg article is an addendum to my written testimony.

We know that the larger issues of financial regulatory reform are beginning to receive consideration by you and your colleagues here in Congress. While we don't have detailed views on regulatory reform, we believe the key concept to keep in mind is to apply modern regulatory concepts like the principles-based approach to regulation practiced successfully by the CFTC and regulators around the world. We hope that the process of updating U.S. regulation will retain the CFTC's principle-based approach and expand that approach throughout our regulatory framework where appropriate.

Mr. Chairman, NASDAQ OMX supports your interest in prohibiting over-the-counter trading of carbon offset credit futures. NASDAQ owns a carbon trading facility in Europe called NordPool. NordPool was the pioneer in carbon products - the first exchange worldwide to list carbon allowances (EUA) and carbon credits (CER). And, although NordPool is the number 2 marketplace for carbon in Europe, 70% of all trading now takes place in the OTC space, away from effective regulation and supervision. Therefore, it is impossible to know the exact volumes that are traded. Our experience in Europe suggest that the opaque use of OTC derivatives in the European Cap and Trade experiment contributed to the chaos and failure of that marketplace. We want NordPool to be part of the U.S. market solution for greenhouse gas emission reductions and look forward to working with you and the Committee towards ensuring that your legislation allows that expertise to be part of the equation.

Finally, Mr. Chairman, we must be mindful that these OTC instruments ignore international borders and jurisdictions. So we agree with President Obama that these issues can not be handled only with domestic action. For many reasons, working through multilateral structures like the G20 will ensure that the global markets work together on what is a global problem. In this way we will ensure that regulatory arbitrage is minimized and market participants are not driven to engage in "jurisdiction shopping." We understand that President Obama hopes to make these issues, and a coordinated global response, a key aspect of the G20 meeting in April and NASDAQ OMX supports the President's leadership on this matter.

Again, thank you for inviting NASDAQ OMX to testify and for your efforts to bring transparency and order to these important marketplaces. We look forward to working with you and the full Committee membership as you seek to tackle these important public policy challenges.

## *Additional Exhibit*

California Probes Muni Derivatives as Deficit Mounts (Update1)

By William Selway and Martin Z. Braun



Jan. 23 (Bloomberg) -- California is investigating whether Wall Street banks and financial advisers conspired to overcharge local governments for derivative contracts tied to municipal bonds, a state official said.

The antitrust investigation, with Connecticut and Florida launching similar efforts, follows inquiries by the U.S. Justice Department and class action lawsuits by cities from Oakland to Baltimore. They claim banks and advisers cost taxpayers money by rigging bids or fixing prices on financial contracts.

The investigations center on the investments that schools, states and cities buy with the proceeds of some of the \$400 billion of municipal bonds they sell annually and on the interest-rate swaps designed to guard against swings in borrowing costs, authorities have said. Financial advisers are hired to solicit bids for the investments and to determine if their government clients pay fair rates in swaps, which are unregulated instruments not traded on exchanges.

States “almost have no choice but to join in because it involves their towns and cities and maybe even the states themselves,” said Christopher “Kit” Taylor, the former executive director of the Municipal Securities Rulemaking Board, the municipal bond industry regulator. “They’re sitting there saying this is a situation where we may have been taken.”

### Continuing Probes

[Christine Gasparac](#), a spokeswoman for California Attorney General [Jerry Brown](#), confirmed California’s participation. She declined to comment further. The probe comes as the most- populous U.S. state and the biggest issuer of municipal debt struggles to close a record \$42 billion deficit through next year and faces credit rating cuts on \$67 billion of debt.

Connecticut has had a continuing probe. “Our investigation is active and ongoing,” Connecticut Attorney General [Richard Blumenthal](#) said in a statement.

Florida Attorney General [Bill McCollum](#) has sent out 38 subpoenas asking firms for information on sales of derivatives, including guaranteed investment contracts, where

governments place money raised from bond sales until it is needed for projects, said Sandi Copes, a spokeswoman for McCollum.

Among the documents Florida requested were bids and communications between the firms and financial advisers related to the purchase or sale of municipal derivatives, according to the subpoena.

Copes declined to comment further, citing the pending investigation.

U.S. prosecutors and the Securities and Exchange Commission have searched for more than two years for evidence of collusion between banks and brokers to overcharge cities, states and local government agencies.

### Winning Leniency

In February 2007, Charlotte, North Carolina-based Bank of America Corp. was granted leniency by the Justice Department for its cooperation in a national investigation of bid-rigging and price fixing involving municipal derivatives.

In exchange for voluntarily providing information and offering continuing cooperation, the Justice Department agreed not to bring criminal antitrust charges against the bank.

Derivatives are contracts whose value is derived from assets including stocks, bonds, currencies and commodities, or from events such as changes in interest rates or the weather.

“This is a trillion-dollar market, and this goes back to the 1980s,” said [Michael D. Hausfeld](#), an antitrust lawyer representing municipalities, including Fairfax County, Virginia, in a class-action case against 30 banks.

### Rigged Bids

Investigators are looking into whether bidding for guaranteed investment contracts was rigged. U.S. Internal Revenue Service rules require that the agreements be awarded by competitive bidding from at least three banks.

Eight California municipalities, including Los Angeles, Fresno and San Diego County, filed civil class-action, or group lawsuits. The suits, most of which were consolidated with others in U.S. District Court in New York City, allege that banks colluded by deliberately losing bids in exchange for winning one in the future, providing so-called courtesy bids, secretly compensating losing bidders and allowing banks to see other bids.

Brokers participated in the collusion by facilitating communication among banks and sharing in illegal profits, the civil class-action suits allege.

Three advisers to local governments, CDR Financial Products Inc., Sound Capital Management Inc. and Investment Management Advisory Group Inc., were searched by the FBI in November 2006. More than a dozen banks and insurers were subpoenaed and

former bankers at New York-based JPMorgan Chase & Co., [Bear Stearns & Cos.](#) and UBS AG of Zurich were advised over the past year that they may face criminal charges.

New Mexico

Now, federal prosecutors are investigating whether New Mexico Governor [Bill Richardson](#)'s administration steered about \$1.5 million in bond advisory work to CDR, which donated \$100,000 to Richardson's political committees.

CDR also advised Jefferson County, Alabama, on more than \$5 billion of municipal bond and derivative deals. A combination of soaring rates on the bonds and interest-rate swaps is threatening the county with a bankruptcy that would exceed Orange County, California's default in 1994. Jefferson County paid JPMorgan and a group of banks \$120.2 million in fees for derivatives that were supposed to protect it from the risk of rising interest rates.

Those fees were about \$100 million more than they should have been based on prevailing rates, according to James White, an adviser the county hired in 2007, after the SEC said it was investigating the deals.

CDR spokesman [Allan Ripp](#) has said the company stands by the pricing of the swaps and said White's estimates were incorrect because they didn't take into account the county's credit profile, collateral provisions between the county and the banks and the precise time of the derivative trades.

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