

STATEMENT OF GARY GENSLER
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BEFORE THE
HOUSE COMMITTEE ON AGRICULTURE

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Good morning Chairman Peterson, Ranking Member Lucas and members of the Committee. Thank you for inviting me to testify today regarding the regulation of over-the-counter derivatives.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public. We must now do all we can to ensure that it does not happen again. While a year has passed and the system appears to have stabilized, we cannot relent in our mission to vigorously address weaknesses and gaps in our regulatory structure. As a critical component of reform, I believe that we have to bring comprehensive regulation to the over-the-counter (OTC) derivatives markets. We must lower risk, promote greater market integrity and improve market transparency.

The need for reform of our financial system parallels what we faced as a nation in the 1930s. In 1934, President Roosevelt boldly proposed to the Congress “the enactment of legislation providing for the regulation by the Federal Government of the operation of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.” The Congress responded to the then clear need for reform by enacting

the Securities Act of 1933, the Securities Exchange Act of 1934 and the Commodity Exchange Act of 1936.

We need the same type of comprehensive regulatory reform today. Just as we then brought regulation to the commodities and securities markets, we now need to bring regulation to markets for risk management contracts called over-the-counter derivatives.

Comprehensive Regulatory Framework

Comprehensive regulation of the OTC derivatives markets will require two complementary regimes – one for regulation of the derivatives dealers, or the actors, and one for regulation of the derivatives markets, or the stages.

This regulatory framework must cover both standardized and customized swaps. This should include all of the different products, such as interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps, as well as all of the derivative products that may be developed in the future. We should eliminate exclusions and exemptions from regulation for OTC derivatives. Congress should extend the regulatory regimes of the Commodity Exchange Act (“CEA”) and the federal securities laws to fully cover OTC swaps in all commodities. I believe that the law must cover the entire marketplace, without exception.

Only with two complementary regimes that regulate both the derivatives dealers and the derivatives markets can we ensure that federal regulators have full authority to lower risks, promote transparency and prevent fraud, manipulation and other abuses.

This Committee took leadership on OTC derivatives regulation by passing H.R. 977 in February. The joint framework for OTC derivatives legislation announced by Chairmen Peterson and Frank also includes essential provisions to protect the American public

The legislative proposal submitted to Congress by the Treasury Department on behalf of the Obama Administration is a very important step toward comprehensive regulation of the OTC derivatives markets. The CFTC and the Securities and Exchange Commission worked with the Treasury Department on many of the most important provisions of the Administration bill.

Regulating Derivatives Dealers

Only by comprehensively regulating the institutions that deal in derivatives can we oversee and regulate the entire derivatives market. Through regulating the dealers, we can ensure that regulations apply to both standardized and customized products.

Derivatives dealers should be required to meet capital standards and margin requirements to help lower risk. Imposing prudent and conservative capital and margin requirements on all derivatives dealers will help prevent derivatives dealers or counterparties from amassing large or highly leveraged risks outside the oversight and prudential safeguards of regulators. Many of

these dealers, being financial institutions, are currently regulated for capital. I believe, however, that we need to explicitly have in statute and by rule capital requirements for their derivatives exposure. This is even more important for those dealers who are not currently regulated or subject to capital requirements.

Customized derivatives are by their nature less standard, less liquid and less transparent. Therefore, I believe that higher capital and margin requirements for customized products are justified. This Committee addressed the issue of standardized versus customized swaps in H.R. 977.

Congress also should explicitly authorize regulators to require derivatives dealers and counterparties to segregate, or set aside, from their own funds the margin collected from counterparties. This would help ensure that counterparties are protected if either counterparty to the customized OTC transaction experiences financial difficulties.

Dealers should have to comply with business conduct standards to protect market integrity and lower risk. The CFTC and the SEC should be authorized to apply the same enforcement authority that we currently have over the futures and securities markets to OTC derivatives and those who trade them. Both the markets and the public benefit when there is a cop on the beat.

Business conduct standards also should ensure the timely and accurate confirmation, processing, netting, documentation and valuation of all transactions. These standards for “back

office” functions will help reduce risks by ensuring derivatives dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks.

To promote transparency and market integrity, a comprehensive reporting and recordkeeping regime should be established for swaps, including swap repositories – for both standardized and customized products. This should include mandatory public disclosure of aggregate data on swap trading volumes and positions. A complete audit trail of all transactions should be available to the regulators.

The financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system. Every single taxpayer in this room – both the members of this Committee and the audience – put money into a company that most Americans had never even heard of. Approximately \$180 billion of the tax dollars that you and I paid went into AIG to keep its collapse from further harming the economy. The AIG subsidiary that dealt in derivatives – AIG Financial Products – was not subject to any effective federal regulation of its trading. Nor were the derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks. We must ensure that this never happens again. We cannot afford any more multi-billion-dollar bailouts.

Regulating Derivatives Markets

To effectively regulate OTC derivatives and protect the American public, Congress also should establish a comprehensive regulatory regime for the markets in which OTC derivatives trade.

Centralized Clearing: All derivatives that are accepted by central counterparty clearing should be considered “standardized” and thus required to be cleared. This is important to lower risk. The CFTC and SEC should be granted rule writing authority to ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and trading platforms. This is a key component of the bill this Committee passed in February, the Treasury proposal and the regulatory framework announced by Chairmen Peterson and Frank.

Requiring clearing of standardized products will protect the American public by lowering risk. One of the lessons learned from the crisis was that financial institutions were not only too big to fail, but too interconnected to fail. In that regard, moving bilateral trades into regulated clearinghouses will reduce the risk that a failure of one firm will cause other firms to fail.

When a contract is submitted for clearing, the clearinghouse is substituted as the counterparty for both the buyer and the seller. The clearinghouse guarantees the performance for each counterparty, reducing risk for both the buyer and the seller.

Clearinghouses should be required by statute and regulatory action to establish and maintain robust margin standards and other necessary risk controls and measures. It is important

that we incorporate the lessons from the current crisis as well as the best practices reflected in international standards. Thus, the Treasury bill includes provisions strengthening the statutory core principles for derivatives clearing organizations.

To promote transparency and competition, central counterparties should be required to have fair and open access criteria. First, to promote competition among exchanges and trading platforms, clearinghouses should be required to take on OTC derivatives trades from any regulated exchange or trading platform on a nondiscriminatory basis. Second, clearinghouses should accept as clearing members any firm that meets objective, prudent standards to participate, regardless of whether it is a dealer or another type of trading entity. Clearinghouses also should have open governance that incorporates a broad range of viewpoints from members and other market participants.

To meet the requirement that all standardized products be brought into centralized clearing, end-users should be permitted to access clearing through a clearing member. This would establish a client relationship between end-users and clearing members whereby the clearing member would clear the transaction in a client account on behalf of the end-user. This is very similar to what currently exists in the futures marketplaces. I believe it would be appropriate for clearing members, most of whom would be financial institutions, to have the ability to enter into individualized credit arrangements with end-users that are not major market participants to satisfy the margin obligations of such end-users. Thus, we would be able to achieve the goal of bringing all standardized swaps to clearinghouses while concurrently allowing end-users to enter into appropriate, individualized credit terms with a clearing member.

Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdiction. This well-established practice of having the agency which regulates an exchange or trade execution facility also regulate the clearinghouses for that market should continue as we extend regulations to cover the OTC derivatives market.

Exchanges: I believe market transparency and efficiency would be further improved by moving the standardized part of the OTC markets onto regulated exchanges and regulated trade execution facilities. Exchanges greatly improve the functioning of the existing securities and futures markets. We should bring the same transparency and efficiency to the OTC swaps markets.

Transparency in pricing is critical to economic activity. Increasing transparency – including a consolidated reporting tape – for standardized derivatives would give both large and small end-users better pricing on standard and customized products. A corn or wheat farmer, for example, could better decide whether or not to hedge a risk based upon the reported pricing from the exchanges. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will enhance the ability of all end-users to effectively manage their risk, whether hedging or trading with standardized or customized swaps.

Position Limits: The CFTC should be granted statutory authority to set aggregate position limits across all markets and trading platforms on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets that the CFTC oversees. This will ensure that traders cannot evade position limits by moving to a related exchange or market. Exemptions to position limits should be limited and well defined.

Enforcement and Rulemaking Authority: The Congress should strengthen the CFTC's rulemaking, oversight and enforcement authorities with respect to registered exchanges and clearinghouses. Further, the Congress should extend the "Zelener fraud fix," which was included in last year's Farm Bill with respect to CFTC enforcement authority over off-exchange retail foreign currency transactions, to similar contracts in other commodities. I am pleased that these provisions are included in the Administration's proposal.

Foreign Boards of Trade: As part of regulatory reform legislation, the Congress should provide the CFTC with clear statutory authority to regulate U.S. traders on foreign boards of trade. Parties using terminals in the U.S. to trade a contract that settles against the price of a contract traded on a U.S. exchange should be subject to position limits and reporting requirements. Those limits would be consistent with limits that apply to the U.S. exchange. Such requirements were passed by this Committee in February and are included in the Administration bill.

Working with the SEC

Comprehensive regulation of OTC derivatives will require ongoing cooperation between the CFTC and the SEC. The President asked that our agencies provide recommendations to Congress and the Administration on how to best tailor our regulations in the interest of protecting the American public. We recently held two unprecedented joint meetings to look into the gaps that exist between the two agencies' financial regulatory authorities, overlap of regulatory authority and inconsistencies when the two agencies' regulate similar products, practices and markets. The President asked the CFTC and the SEC to propose legislative initiatives, where appropriate, to best harmonize our regulations. It is my hope that some of these proposals will be available to this Committee while you consider legislation regulating the OTC derivatives markets.

We are fortunate to have a great partner in SEC Chairman Mary Schapiro. Since our designations were jointly announced by then President-elect Obama, we have had a strong working relationship. As Chairman of the SEC, former Chairman of the CFTC and CEO of FINRA, Chairman Schapiro brings invaluable expertise in both the securities and commodity futures areas. Our mutual understanding, dedicated staffs and respective Commission support gives me great confidence that we will be able to get the job done.

Resources

The CFTC will need additional resources for new staff and technology to effectively regulate the OTC markets. The Commission is just this year getting back to the staffing levels that it had in the late 1990s. Since then, the markets grew five-fold and the number of contracts

grew six-fold, but the agency's staff was cut by more than 20 percent. To take on additional oversight responsibilities, we will continue to work with this Committee, the Appropriations Committees, Congress and the Office of Management and Budget to secure additional resources.

Conclusion

I look forward to working with the Congress and other federal regulators to apply comprehensive regulation to both derivatives dealers and the markets in which they trade. The United States thrives in a regulated market economy. This requires innovation, competition and regulation to ensure that our markets are fair and orderly. We have a tough job ahead of us, but it is essential that we get it done to protect the American public.

Thank you for inviting me to testify today. I would be happy to answer any questions you may have.