

TESTIMONY OF GARY GENSLER
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BEFORE THE
U.S. HOUSE COMMITTEE ON AGRICULTURE
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Good morning Chairman Lucas, Ranking Member Peterson and members of the Committee. I thank you for inviting me to today's hearing on the Commodity Futures Trading Commission's (CFTC) progress thus far on rules relating to entity and product definitions under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am pleased to testify on behalf of the CFTC. I also thank my fellow Commissioners for their hard work and commitment on implementing the legislation.

The Dodd-Frank Act for the first time brought oversight to the swaps market. By bringing comprehensive regulation to swap dealers and mandating that standardized swaps be brought to clearing and transparent trading, the Dodd-Frank Act helps lower risk to the American public and bring transparency, openness and competition to these markets.

The Dodd-Frank Act was very detailed with regard to entity and product definitions as well as the exception from clearing for non-financial end-users. Congress did direct the CFTC, however, working with the Securities and Exchange Commission (SEC) and in consultation with the Federal Reserve, to further define those entities and products. The Dodd-Frank Act further

provides the CFTC with authority to write rules with regard to the non-financial end-user clearing exception.

This afternoon I will discuss the joint rule on entity definitions that was proposed last fall, the CFTC's and SEC's work to propose a product definitions rulemaking and the CFTC's proposed rule with regard to the non-financial end-user exception from clearing. I also will briefly discuss the CFTC's rule-writing process and authority to phase effective dates of final rules. The CFTC and the SEC jointly released an advance notice of proposed rulemaking in September to seek public comment on entity and product definitions. Those comments informed both agencies as we worked to propose a joint rule on entity definitions and as we continue to work on a product definitions proposed rulemaking.

Entity Definitions Rulemaking

The Dodd-Frank Act defined two categories of market participants that would be subject to comprehensive regulation by the CFTC: swap dealers and major swap participants. This comprehensive regulation includes capital and margin requirements, business conduct standards and recordkeeping and reporting requirements.

On December 1, 2010, the CFTC proposed a rule jointly with the SEC to fulfill Congress's direction to further define the terms "swap dealer," "major swap participant," "security-based swap dealer," "security-based major swap participant" and "eligible contract participant." The comment period ran through February 22, 2011. There are presently 180

comments in the comment file, including those that were received after the comment period closed. The Commission is considering all of these comments.

The proposed swap dealer definition closely follows the criteria laid out by Congress. These criteria include whether an entity makes a market in swaps, holds itself out as a swap dealer, is commonly referred to as a swap dealer or regularly enters into swaps in the ordinary course of business.

The proposed rule identified characteristics to be considered in determining whether persons are swap dealers, including whether they tend to accommodate demand for swaps from other parties; are generally available to enter into swaps to facilitate other parties' interest; tend not to request that other parties propose the terms of swaps; tend to enter into swaps on their own standard terms or on terms they arrange in response to other parties' interest; and tend to be able to arrange customized terms for swaps upon request, or to create new types of swaps at their own initiative.

The Dodd-Frank Act and the proposed joint rule provide an exclusion for an insured depository institution "to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." The exclusion in the proposed rule would apply to swaps that are connected to the financial terms of the loan itself.

The Dodd-Frank Act and the Commissions' joint proposed rule provide an exemption for a person who "engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers."

The Dodd-Frank Act also defined another category of market participants that would be subject to comprehensive regulation, called major swap participants. These entities were defined as those that are not otherwise swap dealers and whose failure would have systemic ramifications given their substantial participation in the swaps market.

The major swap participant definition relies on Congress's three-prong test. In each of the three prongs, the Dodd-Frank Act spoke to an entity that has a substantial position in swaps or substantial counterparty exposure. The proposed rule focuses on net uncollateralized current exposure and potential future exposure. Therefore, it takes into consideration entities' uncleared versus cleared swaps as well as any netting or collateral arrangements that they may have with their counterparties.

Under the statute and the proposed rule, the major swap participant category is very clearly limited only to those non-swap dealer entities that have risk large enough to pose a threat to the U.S. financial system. It is likely that, under the joint proposed rule, this category will include only a handful of entities.

The joint proposed rule includes two changes to the definition of eligible contract participant (ECP). First, the proposed rule explicitly includes swap dealers and major swap

participants within the definition of ECP. Second, the rule proposes clarifications to how certain commodity pools use retail foreign exchange products. These commodity pools must meet certain specific requirements of the current ECP definition.

Product Definitions

The Dodd-Frank Act was very specific in defining derivatives products that will be required to be regulated. The Act covers the entire swaps marketplace – both bilateral and cleared – and the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps.

The CFTC is working closely with the SEC on a proposed rule to further define swaps, security-based swaps, mixed swaps and security-based swap agreements, which are defined terms in the Dodd-Frank Act. We hope to jointly propose the products definitions rule in the near future.

In preparing the proposed rule, staff has been working to address the more than 80 comments that were submitted by the public in response to the joint advance notice of proposed rulemaking on definitions. Many of the commenters asked that the Commissions specifically provide guidance on what is not a swap or security-based swap.

Though staff is yet to make a formal recommendation to the two Commissions, I would like to address some thoughts on three areas.

Under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there has been a series of orders, interpretations and cases that market participants have come to rely upon regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of swaps “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.” I believe it would be appropriate to interpret that exclusion in a manner that is consistent with the Commission’s previous history of the forward exclusion from futures regulation, including the Commission’s treatment of bookouts.

Further, commenters have expressed the view that Congress did not intend that the swap definition include state or federally regulated insurance products that are provided by regulated insurance companies. The staffs of the Commissions are working to address these comments in a way that clarifies what products are insurance and therefore would not be considered swaps. In addition, commenters have suggested that the Commissions clarify that certain consumer and commercial arrangements that historically have not been considered swaps, such as consumer mortgage rate locks, contracts to lock the price of home heating oil and contracts relating to inventory or equipment, also should not be considered within the swap definition. The staffs of the Commissions also are working to address these comments in a way that clarifies that these products are not swaps.

End-User Exception

A central component of the Dodd-Frank Act is its provision to lower risk in the financial system by generally requiring the clearing of standardized swaps through regulated clearinghouses. Central clearing has been a feature of the U.S. futures markets since the late-19th century. Clearinghouses have functioned both in clear skies and during stormy times – through the Great Depression, numerous bank failures, two world wars and the 2008 financial crisis – to lower risk to the economy. Congress excepted swaps transactions involving non-financial end-users from the clearing requirement because they do not pose the same risk as transactions between two financial entities.

The CFTC proposed a rule on December 9, 2010 relating to the end-user exception. We have received 1,039 comments in response to the proposal. In essence, the proposal says that, if a non-financial company is using a swap to hedge an asset, liability, input or service that it currently has or uses or anticipates having or using, it would qualify for the end-user exception. In addition, the proposal says that if a swap meets generally accepted accounting principles as a hedge or if it is used for bona fide hedging, then the transaction would qualify for the end-user exception. Non-financial entities would be able to hedge interest rate risk, currency risk, physical commodity risk or other types of risk.

The proposed rule does, however, say that if an entity is taking a position to speculate, the transaction would not qualify for the end-user exception.

The Dodd-Frank recognized that swaps transactions involving non-financial end-users do not pose the same risk as transactions between two financial entities. Thus, the CFTC does not intend to impose margin requirements with regard to these transactions.

CFTC Rule-Writing Process

At this point in the process, the CFTC has come to a natural pause as we have now promulgated proposals in most of the areas required by the Dodd-Frank Act. As we receive comments from the public, we are looking at the whole mosaic of rules and how they interrelate. We will begin considering final rules only after staff can analyze, summarize and consider public comments, after the Commissioners are able to discuss the comments and provide direction to staff, and after the Commission consults with fellow regulators on the rules. We hope to move forward in the spring, summer and fall with final rules.

Phasing of Implementation

The Dodd-Frank Act gave the CFTC flexibility as to setting implementation or effective dates of the rules to implement the Dodd-Frank Act. For example, even if we finish finalizing rules in a particular order, that doesn't mean that the rules will be required to become effective in that order. Effective dates and implementation schedules for certain rules may be conditioned upon other rules being finalized, their effective dates and the associated implementation schedules. For instance, the effective dates of some final rules may come only after the CFTC and SEC jointly finalize the entity or product definitions rules.

The Commission has the authority to phase implementation dates based upon a number of factors, including asset class, type of market participant and whether the requirement would apply to market platforms, like clearinghouses, or to specific transactions, such as real time reporting. For example, a rule might become effective for one asset class or one group of market participants before it is effective for other asset classes or other groups of market participants. We are looking to phase in implementation, considering the whole mosaic of rules. We look forward to hearing from market participants and regulators, both in the U.S. and abroad, regarding the phasing of implementation.

Regardless of the eventual effective dates of the swaps rules, to provide regulatory certainty to the market, rules relating to mandatory clearing, real time reporting, the trading requirement, margin and business conduct standards will apply only prospectively to those transactions that are executed after the rules go into effect.

Conclusion

I again thank you again for inviting me to testify today. I'd be happy to take questions.