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Remarks

Remarks of Chairman Gary Gensler, CFTC's Role in Cap-and-Trade, IETA 2009 Fall Symposium

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Good afternoon. It is a pleasure to be with you today. I'd like to thank the International Emissions Trading Association for inviting me to speak on the need for comprehensive reform of over-the-counter derivative markets as well as appropriate regulation of carbon emissions trading markets.

The Commodity Futures Trading Commission's predecessor was established in response to an earlier crisis in the 1930s to oversee the markets for commodities and risk management contracts. With subsequent market developments, we now regulate the markets for derivatives, ranging from interest rates, currencies, wheat, energy, other commodities and even emissions allowances. Some of these contracts, called futures, are traded on regulated, transparent exchanges. Other derivatives, called swaps or over-the-counter derivatives, are traded between two parties and currently are not subject to regulation.

The CFTC and the Administration are currently working with Congress to bring comprehensive regulation to over-the-counter derivatives. Though there are certainly many causes of our current financial crisis, I think most would agree that the unregulated over-the-counter derivatives marketplace played a central role. The time has come for comprehensive regulation.

The Administration took a crucial step toward regulating these markets in August by sending comprehensive legislative language to Congress. In just the past three weeks, two important committees in the U.S. House of Representatives – the Financial Services Committee and the Agriculture Committee – both passed historic legislation that, for the first time, introduces regulation to the OTC derivatives marketplace.

Both of the committees' bills include three important elements of regulatory reform: First, they require swap dealers and major swap participants to register and come under comprehensive regulation. This includes capital standards, margin requirements, business conduct standards and recordkeeping and reporting requirements. Second, they require dealers and major swap participants to use transparent trading venues for their swaps as well as provide the CFTC with authority to impose position limits in the OTC derivatives markets. Third, the bills require that dealers and major swap participants bring their clearable swaps into central clearinghouses.

Last year's crisis highlighted all too well how opaque markets can threaten the financial system and the American public. There has neither been transparency to the public nor to the regulators in these markets. To promote transparency to regulators, recordkeeping and reporting should be mandated for all swaps, including both standardized and customized.

But only through public market transparency will we address information deficits for market users. Only through requiring that all standardized over-the-counter derivative products be traded on regulated exchanges or through regulated trade execution facilities will we afford hedgers and other derivatives users the full benefits of an efficient marketplace. Increasing transparency for standardized derivatives should enable both large and small financial institutions, corporations, nonprofits and municipalities to obtain better pricing on standard and customized products. Transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the swaps markets. While the bills recently passed by the House Financial Services and Agriculture Committees are important steps forward in requiring trades to be brought to transparent trading venues, we can build upon this by bringing more transactions into these trading venues, particularly those transactions between dealers and end-users.

Another lesson learned from the financial crisis is that some financial institutions not only had become so large so as to be considered "too big to fail," but also so intertwined so as to be "too interconnected to fail." When big banks deal in derivatives, they maintain on their books trades with other entities or counterparties. This means that if one financial institution fails, it could have an effect on the entire system. The large swap dealers have become interconnected with literally thousands of counterparties located in every sector of our economy and in every state in our nation. This interconnectedness left the government with an untenable decision last year. That is why it is so important to reform the system so that these clearable, or "standardized," transactions, once arranged, are moved off the balance sheets and books of swap dealers.

That's where a clearinghouse comes in. A clearinghouse stands between two parties in a derivative transaction to take on the risk of default by one of the counterparties. All over-the-counter transactions, where clearing is possible, should be required to be cleared by robustly regulated central counterparties. Today, many of the institutions that keep trades on their books simultaneously engage in many other businesses – lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other hand, are solely in the business of clearing trades and managing the associated risk. To reduce systemic risk, it is critical that we move all standard swaps off the books of large financial institutions and into well-regulated clearinghouses.

I believe that all clearable transactions should be required to be brought to a clearinghouse, regardless of what type of entity is on either side of the trade. This would remove the greatest amount of interconnectedness from the large financial institutions. The bills require clearing of transactions between swap dealers or major swap participants. Broadening coverage could result in substantial, further reduction in financial system risk.

If Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow. I believe that it is most critical that transactions with financial firms – and in particular, hedge funds and other investment funds – benefit from a clearing requirement. These entities are responsible for a substantial share of the OTC derivatives market and they are capable of meeting these requirements that have such tremendous promise for the responsible management of financial risk. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system. Thus, I look forward to working with Congress to build upon their strong efforts to move more transactions into robustly regulated clearinghouses.

I believe that comprehensive regulation of OTC derivatives is a critical component of a well functioning emissions trading market as well. As Congress moves forward with potential cap-and-trade legislation, I believe it should fully regulate the expanded carbon trading markets – including the futures market, the OTC market and the cash market – without exception. Ensuring transparency, protecting the price discovery function and addressing financial risk are every bit as critical for emissions markets as other markets.

It is crucial to ensure that carbon markets function smoothly, efficiently and transparently. Effective regulation of carbon allowance trading will require cooperation on the parts of several regulators. There are six regulatory components of carbon markets that I believe should be considered:

1. Standard setting and allocation;

2. Compliance with emissions caps and offset requirements

3. Recordkeeping and maintaining a registry;

4. Overseeing the trade execution system;

5. Overseeing clearing of trades; and

6. Protecting against fraud, manipulation and other abuses.

The first three components – the actual allocation of allowances and offset credits, ensuring compliances with emissions caps and offset requirements, and recordkeeping (other than recordkeeping of the trades) – fall within the expertise of other agencies. In other words, others are well equipped to regulate the “cap” part of “cap-and-trade.”

For example, the EPA currently issues allowances on sulfur dioxide and nitrogen oxide as mandated under the Acid Rain, NOx Budget Trading and Clean Air Market Programs. On a smaller scale, a group of ten states from Maine to Maryland form the Regional Greenhouse Gas Initiative and issue allowances on greenhouse gas emissions. In each case, other entities issue allowances, ensure compliance and maintain the registry. The constant, however, is that the CFTC regulates the emissions futures trading markets. In other words, the CFTC has a great deal of experience regulating the “trade” part of “cap-and-trade.”

Specifically, we have broad experience in the latter three components of carbon trading: regulating trade execution systems and clearing of trades and guarding against fraud, manipulation and other abuses. The Commission already oversees trading and clearing of futures and options contracts based on sulfur dioxide, nitrogen oxide and carbon dioxide allowances and offsets listed on the New York Mercantile Exchange and the Chicago Climate Futures Exchange.

In most respects, emissions contract markets operate similarly to other commodity markets the CFTC regulates. While each contract – such as sulfur dioxide, wheat, treasury bills or natural gas – presents its own unique challenges, the regulatory scheme is essentially the same.

The Commission has thorough processes to ensure that exchanges have procedures in place to protect market participants and ensure fair and orderly trading, that products are designed to minimize potential manipulation and that exchanges comply with the law and regulations. The Commission’s compliance staff actively monitors operations to ensure that exchanges are enforcing their rules and that customers are protected from abusive practices. Our surveillance staff keeps a close eye for signs of manipulation or congestion and determines how to best address market threats. We have the authority to set and enforce position limits, and our enforcement staff is actively prosecuting cases.

The CFTC has wide-ranging transparency efforts designed to provide as much information to the American public as possible. Specifically, the Commission publishes weekly Commitments of Traders reports, quarterly data on index investment, a “This Month in Futures Markets” report and annual financial data for futures commissions merchants and futures industry registrants. We are prepared to make sure that expanded carbon markets benefit from the same transparency.

Should Congress pass cap-and-trade legislation, the CFTC would work with other regulators to implement any additional safeguards that are appropriate for this marketplace. There may be specific facets of carbon markets that require particular protections, and I look forward to working with Congress, market participants and the public to offer the Commission’s expertise in considering those. As a foundation, the markets should benefit from the protections that we currently have against fraud, manipulation and other abuses as directed by the Commodity Exchange Act coupled with any new protections Congress is considering for the OTC derivatives markets. We also must ensure that all transactions in both the carbon futures and cash markets are promptly reported and that a central registry is updated at least on a daily basis. With immediate registry of trades, it will be easier for regulators to identify manipulation in the markets.

It is important that companies are able to make long-term capital commitments and hedge their long-term price risk of carbon emissions allowances. That is why it is critical to get the regulatory oversight right of both the futures markets and the over-the-counter markets that may develop out of a cap-and-trade program.

With that, thank you for inviting me to speak today. I look forward to questions from the audience. I kindly ask that the press save their questions for after the Q and A.