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Testimony

Statement of Gary Gensler Chairman, Commodity Futures Trading Commission

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Good morning Chairman Harkin, Ranking Member Chambliss, and Members of the Committee. Thank you for your unanimous vote of confidence on my recent confirmation and for inviting me to testify. I am here today testifying on behalf of the Commission.

The topic of this hearing is of utmost importance during this crucial time for our economy. We must urgently enact broad reforms to regulate over-the-counter (OTC) derivatives. Such reforms must comprehensively regulate both derivative dealers and the markets in which derivatives trade. This is vitally important for the future of our economy and the welfare of the American people. I pledge to work closely with this Committee and the Congress on these reforms to build and restore confidence in our financial regulatory system.

In addition to working toward this much needed reform, I also will work to ensure that the Commodity Futures Trading Commission (CFTC) continues to fulfill its basic mission under the Commodity Exchange Act (CEA) to protect the integrity of the futures markets. I look forward to working with you to improve the capabilities and authorities of the CFTC to ensure that both our futures markets and the OTC derivatives markets are transparent and free from fraud, manipulation and other abuses.

Comprehensive Regulatory Framework

A comprehensive regulatory framework governing OTC derivative dealers and OTC derivative markets should apply to all dealers and all derivatives, no matter what type of derivative is traded or marketed. It should include interest rate swaps, currency swaps, commodity swaps, credit default swaps, and equity swaps. Further, it should apply to the dealers and derivatives no matter what type of swaps or other derivatives may be invented in the future. This framework should apply regardless of whether the derivatives are standardized or customized.

A new regulatory framework for OTC derivatives markets should be designed to achieve four key objectives:

- Lower systemic risks;
- Promote the transparency and efficiency of markets;
- Promote market integrity by preventing fraud, manipulation, and other market abuses, and by setting position limits; and
- Protect the public from improper marketing practices.

To best achieve these objectives, we must implement two complementary regulatory regimes: one focused on the dealers that make the markets in derivatives and one focused on the markets themselves – including regulated exchanges, electronic trading systems and clearing houses. Only with these two complementary regimes will we ensure that federal regulators have full authority to bring transparency to the OTC derivatives world and to prevent fraud, manipulation, other types of market abuses, as well as to impose position limits to prevent the burdens of excessive speculation. These two regimes should apply no matter which type of firm, method of trading or type of derivative or swap is involved.

Regulating Derivatives Dealers

I believe that we must explicitly regulate the institutions that deal in derivatives. In addition, regulations should cover any other firms whose activities in these markets can create large exposures to counterparties.

The current financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system and that all such firms should be subject to robust Federal regulation. The AIG subsidiary that dealt in derivatives – AIG Financial Products – for example, was not subject to any effective regulation. The derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks were not subject to mandatory regulation either.

By fully regulating the institutions that trade or hold themselves out to the public as derivative dealers we can oversee and regulate the entire derivatives market. I believe that the Commodity Exchange Act should be amended to provide for the registration and regulation of all derivative dealers.

The full, mandatory regulation of all derivatives dealers would represent a dramatic change from the current system in which some dealers can operate with limited or no effective oversight. Specifically, all derivative dealers should be subject to capital requirements, initial margining requirements, business conduct rules and reporting and recordkeeping requirements. Standards that already apply to some dealers, such as banking entities, should be strengthened and made consistent, regardless of the legal entity where the trading takes place.

Capital and Margin Requirements. The Congress should explicitly require regulators to promulgate capital requirements for all derivatives dealers. Imposing prudent and conservative capital requirements, and initial margin requirements, on all transactions by these dealers will help prevent the types of systemic risks that AIG created. No

longer would derivatives dealers or counterparties be able to amass large or highly leveraged risks outside the oversight and prudential safeguards of regulators.

Business Conduct and Transparency Requirements. Business conduct standards should include measures to both protect the integrity of the market and lower the risk (both counterparty and operating) from OTC derivatives transactions.

To promote market integrity, the business conduct standards should include prohibitions on fraud, manipulation and other abusive practices. These standards also should require adherence to position limits established by the CFTC on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.

Business conduct standards 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 derivative dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks.

Derivatives dealers also should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements should include retaining a complete audit trail and mandated reporting of any trades that are not centrally cleared to a regulated trade repository. Trade repositories complement central clearing by providing a location where trades that are not centrally cleared can be recorded in a manner that allows the positions, transactions, and risks associated with those trades to be reported to regulators. To provide transparency of the entire OTC derivatives market, this information should be available to all relevant federal financial regulators. Additionally, there should be clear authority for regulating and setting standards for trade repositories and clearinghouses to ensure that the information recorded meets regulatory needs and that the repositories have strong business conduct practices.

The application of these business conduct standards and the transparency requirements will enable regulators to have timely and accurate knowledge of the risks and positions created by the dealers. It will provide authorities with the information and evidentiary record needed to take any appropriate action to address such risks and to protect and police market integrity. In this regard, the CFTC should have clear, unimpeded oversight and enforcement authority to prevent and punish fraud, manipulation and other market abuses.

Market transparency should be further enhanced by requiring that aggregated information on positions and trades be made available to the public. No longer should the public be in the dark about the extensive positions and trading in these markets. This public information will improve the price discovery process and market efficiency.

Regulating Derivatives Markets

In addition to the significant benefits to be gained from broad regulation of derivatives dealers, I believe that additional safety and transparency must be afforded by regulating the derivative market functions as well. We should require that all derivatives that can be moved into central clearing be required to be cleared through regulated central

clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems.

Requiring clearing and trading on exchanges or through regulated electronic trading systems will promote transparency and market integrity and lower systemic risks. To fully achieve these objectives, we must enact both of these complementary regimes. Regulating both the traders and the trades will ensure that we cover both the actors and the actions that may create significant risks.

Exchange-trading and central clearing are the two key and related components of well-functioning markets. 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 clearing houses for that market should continue as we extend regulations to cover the OTC derivatives market. In implementing these responsibilities it may be appropriate as well to consider possible additional information and other requirements of any systemic risk regulator that may be established by Congress.

Central Clearing. Central clearing should help reduce systemic risks in addition to the benefits derived from comprehensive regulation of derivatives dealers.

Clearing reduces risks by facilitating the netting of transactions and by mutualizing credit risks. Currently, most of the contracts entered into in the OTC derivatives market are not cleared, and remain as bilateral contracts between individual buyers and sellers. In contrast, when a contract between a buyer and seller is submitted to a clearinghouse for clearing, the contract is “novated” to the clearinghouse. This means that the clearinghouse is substituted as the counterparty to the contract and then stands between the buyer and the seller.

Clearinghouses then guarantee the performance of each trade that is submitted for clearing. Clearinghouses use a variety of risk management practices to assure the fulfillment of this guarantee function. Foremost, derivatives clearinghouses would lower risk through the daily discipline of marking to market the value of each transaction. They also require the daily posting of margin to cover the daily changes in the value of positions and collect initial margin as extra protection against potential market changes that are not covered by the daily mark-to-market. These practices are similar to the way clearinghouses for futures exchanges operate.

The regulations applicable to clearing should require that clearinghouses 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. Working with Congress, we should consider possible amendments to the CEA to expand and deepen the core principles that registered derivatives clearing organizations must meet to achieve these goals to both strengthen these systems and to reduce the possibility of regulatory arbitrage. Clearinghouses should have transparent governance arrangements that incorporate a broad range of viewpoints from members and other market participants.

Central counterparties should also be required to have fair and open access criteria that allow any firm that meets objective, prudent standards to participate regardless of whether it is a dealer or a trading firm. Additionally, central clearinghouses should implement rules that allow indirect participation in central clearing. By novating contracts to a central clearinghouse coupled with effective risk management practices, the failure of a single trader, like AIG, would no longer jeopardize all of the counterparties to its trades.

One of the lessons that emerged from this recent crisis was that institutions were not just "too big to fail," but rather too interconnected as well. By mandating the use of central clearinghouses, institutions would become much less interconnected, mitigating risk and increasing transparency. Throughout this entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses continued to be cleared and settled.

Exchange-trading. Beyond the significant transparency afforded the regulators and the public through the record keeping and reporting requirements of derivatives dealers, market transparency and efficiency would be further improved by moving the standardized part of the OTC markets onto regulated exchanges and regulated transparent electronic trading systems. Furthermore, a system for the timely reporting of trades and prompt dissemination of prices and other trade information to the public should be required. Both regulated exchanges and regulated transparent trading systems should allow market participants to see all of the bids and offers. A complete audit trail of all transactions on the exchanges or trade execution systems should be available to the regulators. Through a trade reporting system there should be timely public posting of the price, volume and key terms of completed transactions. This system might be similar to the Trade Reporting and Compliance Engine (TRACE) system currently required for timely reporting in the OTC corporate bond market.

The CFTC also should have authority to impose recordkeeping and reporting requirements and to police the operations of all exchanges and electronic trading systems to prevent fraud, manipulation and other abuses.

In contrast to long established on-exchange futures markets, there is a need to encourage the further development of exchanges and electronic trading systems for OTC derivatives. In order to promote this goal and achieve market efficiency through competition, there should be sufficient product standardization so OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another.

Position Limits. Position limits must be applied consistently across all markets, across all trading platforms, and exemptions to them must be limited and well defined. The CFTC should have the ability to impose position limits, including aggregate limits, on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets. Such position limit authority should clearly empower the CFTC to establish aggregate position limits across markets in order to ensure that traders are not able to avoid position limits in a market by moving to a related exchange or market.

Over the past few years, price spikes and unprecedented volatility in the commodity markets have hurt farmers, consumers and businesses. Record-high prices have not only inflicted costs upon American consumers and businesses, but record-high volatility has impaired the ability of many farmers and other businesses to use the futures markets to manage their price risks. As Chairman, I intend to ensure that the CFTC vigorously protects the integrity of the price discovery process in the futures markets and protects the public against fraud, manipulation and other abuses. I intend to ensure the agency does all it can to prevent excessive speculation from causing an undue burden on interstate commerce.

Standardized and Customized Derivatives

It is important that tailored or customized swaps that are not able to be cleared or traded on an exchange be sufficiently regulated. Regulations should also ensure that customized derivatives are not used solely as a means to avoid the clearing requirement. We will accomplish this in two ways. First, regulators should be given full authority to prevent fraud, manipulation and other abuses and to impose recordkeeping and transparency requirements with respect to the trading of all swaps, including customized swaps. Second, we must 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 electronic trading systems.

One way to ensure this would be to establish objective criteria for regulators to determine whether, in fact, a swap is standardized. For example, there should be a presumption that if an instrument is accepted for clearing by a fully regulated clearinghouse, then it should be required to be cleared. Additional potential criteria for consideration in determining whether a contract should be considered to be a standardized swap contract could include:

- The volume of transactions in the contract;
- The similarity of the terms in the contract to terms in standardized contracts;
- Whether any differences in terms from a standardized contract are of economic significance; and
- The extent to which any of the terms in the contract, including price, are disseminated to third parties.

Criteria such as these could be helpful in ensuring that parties are not able to avoid the requirements applicable to standardized contracts by tweaking the terms of such contracts and then labeling them “customized.”

Regardless of whether an instrument is standardized or customized, or traded on an exchange or on a transparent electronic trade execution system, the CFTC should have clear, unimpeded authority to impose recordkeeping and reporting requirements, impose margin requirements, and prevent and punish fraud, manipulation and other market abuses. No matter how the instrument is traded, the CFTC also should have clear, unimpeded authority to impose position limits, including aggregate limits, to prevent excessive speculation. A full audit trail should be available to the CFTC and other Federal regulators.

Authority

To achieve these goals, the Commodity Exchange Act should be amended to provide the CFTC with positive new authority to regulate OTC derivatives. The term "OTC derivative" should be defined, and the CFTC should be given clear authority over all such instruments. To the extent that specific types of OTC derivatives might best be regulated by other regulatory agencies, care must be taken to avoid unnecessary duplication and overlap.

As we enact new laws and regulations, we should be careful not to call into question the enforceability of existing OTC derivatives contracts. New legislation and regulations should not provide excuses for traders to avoid performance under pre-existing, valid agreements or to nullify pre-existing contractual obligations.

Achieving the Four Key Objectives

Overall, I believe the complimentary regimes of dealer and market regulation would best achieve the four objectives outlined earlier. As a summary, let me review how this would accomplish the measures applied to both the derivative dealers and the derivative markets.

Lower Systemic Risk. This dual regime would lower systemic risk through the following four measures:

- Setting capital requirements for derivative dealers;
- Creating initial margin requirements for derivative dealers (whether dealing in standardized or customized swaps);
- Requiring centralized clearing of standardized swaps; and
- Requiring business conduct standards for dealers.

Promote Market Transparency and Efficiency. This complementary regime would promote market transparency and efficiency by:

- Requiring that all OTC transactions, both standardized and customized, be reported to a regulated trade repository or central clearinghouses;
- Requiring clearinghouses and trade repositories to make aggregate data on open positions and trading volumes available to the public;
- Requiring clearinghouses and trade repositories to make data on any individual counterparty's trades and positions available on a confidential basis to the CFTC and other regulators;
- Requiring centralized clearing of standardized swaps;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and
- Requiring the timely reporting of trades and prompt dissemination of prices and other trade information;

Promote Market Integrity. It would promote market integrity by:

- Providing CFTC with clear, unimpeded authority to impose reporting requirements and to prevent fraud, manipulation and other types of market abuses;
- Providing CFTC with authority to set position limits, including aggregate position limits;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and
- Requiring business conduct standards for dealers.

Protect Against Improper Marketing Practices. It would ensure protection of the public from improper marketing practices by:

- Business conduct standards applied to derivatives dealers regardless of the type of instrument involved; and
- Amending the limitations on participating in the OTC derivatives market in current law to tighten them or to impose additional disclosure requirements, or standards of care (e.g. suitability or know your customer requirements) with respect to marketing of derivatives to institutions that infrequently trade in derivatives, such as small municipalities.

Beyond the need to bring broad reform to OTC derivatives dealers and markets, I would like to raise with the Committee two other important matters.

Retail fraud. In the 2008 Farm Bill the Congress clarified the CFTC's jurisdiction over fraud in retail foreign currency transactions. Since the passage of the Farm Bill, unscrupulous firms have been offering the same type of fraudulent "rolling spot" commodity contracts that were prohibited in the Farm Bill, but in other commodities that were not covered by the bill. Since the enactment of the Farm Bill, the CFTC has received more than 50 complaints from the public relating to potential fraud from such contracts. The regulatory reform package should include a provision to expand the CFTC's jurisdiction over this type of retail fraud to all types of commodities.

Foreign Boards of Trade. As part of regulatory reform legislation, the Congress should also provide the CFTC with clear statutory authority to ensure that traders that are trading on a foreign board of trade through trading terminals in the U.S. comply with the same U.S. position limits and reporting requirements when trading a foreign contract that settles against any price of a contract traded on a U.S. exchange. Foreign boards of trade should not be permitted to operate in the U .S. unless they impose and enforce comparable position limits on these contracts and provide comparable trading data to the CFTC as is regularly provided by the U.S. exchanges. This is often referred to as "closing the London loophole." Traders in the U.S. should not be able to avoid U.S. position limits or reporting requirements by moving their trades onto a foreign exchange.

Conclusion

The need for reform of our financial system today has many similarities to the situation facing the country 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 swiftly responded to the clear need for reform by enacting the Securities Exchange Act of 1934. Two years later it passed the Commodity Exchange Act of 1936.

It is clear that we need the same type of comprehensive regulatory reform today. Today's regulatory reform package should cover all types of OTC derivatives dealers and markets. It should provide the CFTC and other federal agencies with full authority regarding OTC derivatives to lower risk; promote transparency, efficiency, and market integrity and to protect the American public.

Today's complex financial markets are global and irreversibly interlinked. We must work with our partners in regulating markets around the world to promote consistent rigor in enforcing standards that we demand of our markets to prevent regulatory arbitrage.

These policies are consistent with what I laid out to this committee in February and the Administration's objectives. I look forward to working with this Committee, and others in Congress, to accomplish these goals.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I look forward to answering any questions.