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Remarks

Remarks of Chairman Gary Gensler, OTC Derivatives Regulation, Futures Industry Association Annual Expo

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Good morning. It is a pleasure to be in Chicago with you today at one of the defining moments in our nation's financial history. As we speak, Congress is taking up broad regulatory reform. One year ago, the financial system failed the American public. The financial regulatory system failed the American public.

Congress swiftly committed more than $700 billion of taxpayer money to rescuing the financial industry – without which the financial system never would have stabilized. The crisis was not isolated to Bear Stearns, Lehman Brothers or AIG. It threatened the savings and livelihoods of every American. Let us recall, the financial bailout was only a means of getting a sinking ship back to port. It is now our responsibility to fix the ship before it can set sail again. We must ensure that this type of failure never threatens our nation again.

I speak to you today as someone who spent half my adult life working on Wall Street. I worked with talented individuals from around the world who operated at the highest levels of professionalism. More broadly, the industry plays a fundamental role in pricing and allocating capital and risk in our economy.

But being talented and working in such a critical industry doesn't mean that individuals can't make mistakes or that the system is flawless. The crisis eased only through strenuous effort and some considerable good fortune. Now we must ensure that the risks generated by the financial sector are never allowed to push us so close to the brink again. Some may accuse us of overreacting and overreaching. But the worst financial crisis in 80 years demands the most comprehensive regulatory reform in generations.

Though there are certainly many causes of the crisis, I think most would agree that the unregulated OTC derivatives marketplace played a central role. The time has come for comprehensive regulation.

In just the past week, two important committees in the U.S. House of Representatives – the Financial Services Committee and the Agriculture Committee – took up this reform. The House Financial Services Committee passed historic legislation that, for the first time, introduces comprehensive regulation to the OTC derivatives marketplace. The House Agriculture Committee is marking up a similarly historic bill later today.

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, the bills require that dealers and major swap participants bring their clearable swaps into central clearinghouses. Third, they require dealers and major swap participants to use transparent trading venues for their clearable swaps.

The challenge remains, though, determining which transactions should be covered by these reforms. I believe that we must bring as many transactions under the regulatory umbrella as possible. This will best accomplish the two principal goals of reform: lowering risk to the American public and promoting transparency of the markets.

One of the lessons learned from last year's crisis is the financial system can sometimes concentrate and heighten risk. In that regard, all OTC transactions, where possible, should be required to be cleared by robustly regulated central counterparties. This should include both transactions between two swap dealers or major swap participants as well as transactions with financial and corporate end-users. Today, trades mostly remain on the books of large complex financial institutions, which internalize the volatile risks of their positions. These institutions 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.

To accommodate end-users' concerns regarding margin, they should be permitted to enter into individualized credit arrangements with the clearing members that transact on their behalf. Regulators would not require a particular form of collateral – end-users would simply be required to work with the clearing firm to determine an appropriate credit arrangement. In this way, we would not leave an entire class of transactions out of comprehensive regulatory reform.

If Congress decides to exempt end-users from a clearing requirement, that exception should be very narrowly defined to include only nonfinancial entities that use swaps as an incidental part of their business to hedge actual commercial risks. I do not believe that hedge funds, financial firms or other investment funds should be exempted from a clearing requirement.

To promote market transparency, all standardized OTC products should be moved onto regulated exchanges or trade execution facilities. This is the best way to reduce information deficits for participants in these markets. Transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the swaps markets. Increasing transparency for standardized derivatives should enable both large and small end-users to obtain better pricing on standard and customized products. A municipality, for example, could better decide whether or not to hedge an interest rate based upon the reported pricing from the broader market. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will benefit all end-users, whether trading with standardized or customized swaps.

I believe that we can separate the debate of a corporate end-user clearing exception from whether there should be an end-user exception from transparency requirements. Transactions between swap dealers and end-users, even if the end-users are exempt from margin requirements, should still be traded on exchanges or swap execution facilities. This will best promote the price discovery function of the markets.

I recognize that the additional transparency afforded through exchange trading would be a significant change for many financial institutions. Transparency benefits the public, shifting some of the information advantage from Wall Street to Main Street. I also understand that lowering risk in the system could affect business on Wall Street. When I worked on Wall Street, I often heard the mantra that "volatility is our friend." Risk can often mean greater profit margins. But for the American public, volatility was anything but a friend when it resulted in a $700 billion rescue package.

History will judge us based upon how we respond to this call to action. We will be judged on whether we use the lessons of the financial crisis to reform the system or if we allow it to remain unchanged.

Some have articulated a false choice between stronger regulation on the one hand and a free market on the other. Rules improve markets, however, by enhancing efficiency and integrity. Traffic lights require you to stop your car, but they also ensure that traffic is orderly and efficient. They reduce risks for every person on the highway. Similarly, this country's markets work best with clear rules of the road.

Some have argued that regulatory reform in the United States would send markets overseas. Fortunately, the United States is not alone in its push for comprehensive regulatory reform of the OTC swaps markets. Just yesterday, the European Commission announced a broad agenda to reform derivatives regulation. The European Commission's plan includes a central clearing requirement, requires higher capital for customized swaps and mandates exchange-trading of all standardized products. It is encouraging that Europe and the United States are moving in the same direction regarding regulatory reform. Through a cooperative effort, we can best protect the global financial system.

Last year's crisis also highlighted the need for regulators to change. In that regard, the CFTC last week released a joint report with the SEC to bring greater consistency, where appropriate, to our regulatory approaches. While the missions of the CFTC and the SEC may differ, our goal is the same: to protect the public, enhance market integrity and promote transparency. In preparing our report, we set turf aside and focused on those changes that would best benefit the markets and the American people.

We jointly made 20 recommendations where we can change our statutes and regulations to enhance both agencies' enforcement powers, strengthen market and intermediary oversight and facilitate greater operational coordination.

To improve the competitiveness of exchanges and encourage innovation, we have offered a solution to expedite the product approval process. Too often, there had been delays due to jurisdictional disputes between the agencies. We also have proposed legislative and regulatory changes to permit portfolio margining of certain securities, futures and other products within the same account.

We also recommended changes to the CFTC's oversight authority. The Commission can currently only disapprove a rule if it proves that the rule would violate the Commodity Exchange Act. To ensure better oversight of the markets we regulate, particularly as we embark on regulating the OTC derivatives marketplace, the joint harmonization report recommended that the CFTC have the authority to write rules or approve exchange or clearinghouse rules before they are implemented.

The CFTC also should have greater authority to address disruptive trading practices in the futures markets, enhancing our ability to guard against manipulation. Further, we have recommended that we extend insider trader prohibitions to include parties who receive misappropriated information from any government agency. We call this the Eddie Murphy rule after the movie "Trading Places." To protect consumers, we have advised that all entities that perform investment advisory services should be governed by the same fiduciary standard, regardless of whether they advise in commodities or securities.

The joint report is only a step in the long process toward better-coordinated market regulation. We will continue to build on the report by working with Congress to implement our recommendations. We also will continue to work cooperatively with the SEC to make additional recommendations as necessary.

I do believe that much needs to change to protect the American public – both in the markets that are currently regulated and in the over-the-counter markets. We must ensure that last year's crisis was the last. The Futures Industry Association and all of the participants at this week's expo will play vital roles in the regulatory reform debate. I look forward to working with you.

Thank you for inviting me to speak today. I will now take any questions that you may have.