Commodity Futures Trading Commission
Office of Public Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Testimony

Testimony of Chairman Gary Gensler Before the House Committee on Energy and Commerce, Subcommittee on Energy and the Environment

December 2, 2009

Good afternoon Chairman Markey, Ranking Member Upton and members of the Subcommittee. Thank you for inviting me to testify regarding the regulation of over-the-counter (OTC) derivatives, particularly with respect to energy markets.

Last year's crisis marked a defining moment in our nation's history. The crisis was a call to action for the Administration, Congress and market regulators to ensure that we do all we can to prevent the financial system from so undermining the economy and the wellbeing of the American public. Though there are certainly many causes of the crisis, I think most would agree that the unregulated OTC derivatives marketplace played a central role.

CFTC Regulatory Regime

Before I get to OTC derivatives, I will take a moment to discuss what the CFTC does and our current oversight of energy futures.

The CFTC is responsible for regulating certain types of markets for risk management contracts, also known as derivatives. Many of these contracts, including futures on interest rates, currencies, wheat, energy and other commodities, are traded on regulated, transparent exchanges. Other types of derivatives, called swaps or over-the-counter derivatives, are traded between two parties and, for the most part, are currently excluded by statute from regulation.

With regard to the trading of futures contracts and commodity options, the CFTC has thorough processes to ensure that exchanges have procedures in place to protect market participants and ensure fair and orderly trading, free from fraud, manipulation and other abuses. Exchanges and trading venues are where buyers and sellers meet, prices are negotiated and discovered, trades are affirmed and transaction prices and volumes are reported in a timely manner.

The oversight of clearing is an integral part of the CFTC's regulatory structure. By guaranteeing the performance of contracts submitted for clearing, the clearing process significantly reduces systemic risks. Clearinghouses are different from trading venues in that they help lower risk to the parties after they enter into the trade. Through the discipline of a daily mark-to-market process, the settling of gains and losses and the imposition of independently calculated margin requirements, regulated clearinghouses ensure that the failure of one party to OTC derivatives contracts will not result in losses to its counterparties. The Commission has extensive experience and a well-established program to ensure derivatives clearing organizations and clearing firms have safeguards to ensure orderly clearing and settlement of transactions and safekeeping of customer funds.

The CFTC has wide-ranging transparency efforts designed to provide as much information about commodity futures markets and trading to the American public as possible under current law. The agency also has broad surveillance powers to police the markets for fraud, manipulation and other abuses.

Further, as directed by statute, the CFTC is currently seriously looking into whether position limits should be set in the energy markets as they currently are in many agricultural markets. In setting position limits for certain agricultural commodities, the CFTC sought to ensure that the markets were made up of a broad group of market participants with a diversity of views. Similarly, working with the exchanges, such position limits were set for energy futures as recently as 2001.

While the CFTC does not set prices, it ensures that commodity markets are fair and orderly. Futures markets not only provide critical risk management tools for oil producers, utility companies and other market participants, but they also affect the decisions families make around the dinner table. Gasoline prices, for example, can determine whether a family takes a summer vacation, and the prices of natural gas futures contracts can affect a homeowner's utility bills.

While many different federal agencies oversee the various cash markets throughout the economy, Congress determined that the CFTC should be the sole agency to oversee trading on futures exchanges. One of the principal reasons that Congress mandated this exclusive jurisdiction was to bring uniformity to the regulation of the futures markets. In doing so, the CFTC was also given the authority to provide exemptions from the agency's oversight for specific instruments or markets where it is in the public interest to do so.

The CFTC's exclusive jurisdiction over the futures markets coexists with other agencies' jurisdiction over the underlying commodities. In addition, the agency has a long history of cooperation with other agencies, including periodic joint enforcement meetings, memoranda of understanding and surveillance briefings. The Department of Agriculture, for example, regulates marketing standards for corn and cash milk prices, while the CFTC regulates corn and milk futures. The Grain Inspection, Packers and Stockyards Administration oversees livestock markets, while the CFTC regulates livestock futures. The Treasury Department oversees the issuance of all Treasury Bills, Notes and Bonds, while the CFTC oversees Treasury futures. The Federal Reserve Board oversees interest rate levels, while the CFTC oversees interest rate futures contracts. The Federal Energy Regulatory Commission (FERC) oversees many elements of the energy markets, including natural gas pipelines and electricity markets, while the CFTC oversees natural gas and electricity futures.

Regulation of Energy Futures Markets

A transparent and consistent playing field for all physical commodity futures – from agricultural products, such as corn and wheat to energy products, such as crude oil and natural gas – should be the foundation of our regulations. The CFTC has a long history in the oversight of the futures markets for energy commodities. The agency currently oversees the trading of futures and options on futures on crude oil, heating oil, natural gas, gasoline and electricity, among others, traded on designated contract markets (DCMs), such as the New York Mercantile Exchange (NYMEX), and on some exempt commercial markets (ECMs), such as the Intercontinental Exchange (ICE) and the Nodal Exchange.

Energy futures are a large and vibrant market and important to the American economy. In the first ten months of 2009, more than 315 million energy futures and options contracts were traded on CFTC-regulated exchanges. The largest contract in crude oil by volume was NYMEX's West Texas Intermediate crude oil contract with 114 million contracts. That is the equivalent of 114 billion barrels of oil, with a notional value of nearly $7 trillion. The largest contract in natural gas was NYMEX's Henry Hub natural gas contract with 38 million contracts. That is the equivalent of 380 billion mmBTU's of natural gas with a notional value of $1.6 trillion. Energy futures markets also include very significant trading in electricity contracts, which, as a class, had more than 23.5 million contracts traded representing 7.5% of the overall volume in the energy sector.

Congress has continued to reaffirm the CFTC's role in regulating futures markets. In last year's Farm Bill, Congress strengthened the CFTC's authority over certain energy derivatives trading. Under the Farm Bill, if a contract that is traded on an exempt commercial market (ECM) is found to perform a significant price discovery function, the ECM is subject to heightened regulation and required to comply with key core principles that also apply to the trading of futures contracts.

In July, the Commission issued an Order finding that the ICE Henry LD1 Fixed Price Contract traded on the Intercontinental Exchange (ICE) serves a significant price discovery function. This ICE natural gas contract is cash settled based on the final settlement price of the NYMEX Henry Hub-based futures contract. The CFTC has sought public comment regarding determinations whether more than 40 additional energy contracts, including natural gas and electricity contracts that are currently traded on exempt commercial markets, are significant price discover contract as mandated in last year's Farm Bill.

OTC Derivatives Regulation

I will now discuss much-needed regulatory reform of the OTC derivatives marketplace. Derivatives play an enormous role in our economy. The total value of derivatives traded in the United States is based on a dollar amount nearly 20 times the size of our economy. The arithmetic would suggest that, on average, a $50 tank of gas could have as much as $1,000 in derivatives behind it.

OTC derivative transactions currently occur out of sight of federal regulators and out of sight of market participants. As Congress pursues regulatory reform of OTC derivatives, two principal goals are key: promoting transparency of the markets and lowering risk to the American public.

Improving Transparency

Economists have for decades recognized that transparency benefits the marketplace. After the last great financial crisis facing the nation, President Roosevelt called for transparency in the futures and securities marketplaces. It is now time to promote similar transparency in the OTC derivatives marketplace.

Lack of regulation in these markets has created significant information deficits:

- Information deficits for market participants who cannot observe transactions as they occur and, thus, cannot benefit from the transparent price discovery function of the marketplace;

- Information deficits for the public who cannot see the aggregate scope and scale of the markets; and

- Information deficits for regulators who cannot see and police the markets.

To address information deficits in the OTC derivatives markets, both for energy derivatives as well as non-energy derivatives, the Administration has proposed – and we support – the following priorities:

First, all standardized OTC derivative transactions should be moved onto regulated transparent exchanges or trade execution facilities. This is the best way to address information deficits for market participants. Customized transactions that are so tailored that they are not able to be cleared or listed on an exchange should be allowed, but dealers should be subject to comprehensive regulation. Such transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the OTC derivatives markets.

Increasing transparency – including a timely consolidated reporting system – for standardized derivatives should enable both large and small end-users to obtain better pricing on standardized and customized products. Corporate treasurers across America would find access to trading screens would greatly benefit their ability to determine the best price and hedge their risk. A utility company, for example, could better decide whether or not to purchase natural gas derivative contracts based upon the reported pricing from exchanges. As customized products often are priced in relation to standardized products, mandated trading through transparent trading venues should benefit all end-users, whether trading with standardized or customized swaps. Just as transactions involving end-users are not exempt from trading on existing stock or futures exchanges, all standard contracts should be brought to transparent trade execution facilities.

Second, all transactions that do not occur on trading platforms should be reported to a trade repository that makes the data available to regulators. This will complement regulators' ability to obtain transaction data on trades conducted through a transparent trading venue. U.S. regulators and foreign regulators should both have unfettered access to see all transactions, regardless of whether the physical locations of the trade repositories and clearinghouses are in the United States or elsewhere.

Third, data on OTC derivatives transactions should be aggregated and made available to the public. The CFTC currently collects and aggregates large trader position data and releases it to the public. We should apply the same transparency standards to OTC derivatives. This will promote market integrity and protect the American public.

Fourth, stringent recordkeeping and reporting requirements should be established for swap dealers and major swap participants and vigorously enforced. This should include an audit trail so that regulators can guard against fraud, manipulation and other abuses. Regulators also should have the authority to set aggregate position limits in the OTC markets.

Lowering Risk

To lower risk to the American public from the OTC derivatives markets, the Administration proposed – and we support – four essential components of reform.

First, standard OTC transactions should be required to be cleared by robustly regulated central counterparties. Currently, trades mostly remain on the books of large complex financial institutions. These institutions engage in many other businesses, such as lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other hand, are solely in the business of clearing trades. To reduce systemic risk, it is critical that we move trades off of the books of large financial institutions and into well-regulated clearinghouses. Dealers that enter into customized transactions that are not subject to a clearing requirement should be required to meet heightened capital standards. This would allow end-users to hedge using tailored transactions while limiting risk to the system.

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 risk arising from the interconnectedness of large financial institutions.

If Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow. 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. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system. Moreover, to the extent that any firms are excluded from the clearing requirement, those firms will be left unprotected in the event that a swap dealer or major swap participant is unable to perform its trades. The clearing requirement serves to protect the firm that is required to clear its trades as well as its counterparties. Thus, even if the statute does not require clearing, end-users should have the option to bring their trades to regulated clearinghouses. Furthermore, any exemptions for end-user transactions from a clearing requirement should not also exempt those transactions from a transparent trading requirement.

Second, swap dealers and major swap participants should have sufficient capital. Capital requirements reduce the risk that losses incurred by one particular dealer or the insolvency of one of its customers will threaten the financial stability of other institutions in the system. While many of these dealers, being financial institutions, are currently regulated for capital, we should explicitly – both in statute and by rule – require capital for their derivatives exposure. This is particularly important for nonbank dealers who are not currently regulated or subject to capital requirements.

Third, swap dealers should be required to post and collect margin for individual transactions. Margin requirements reduce the risk that either counterparty to a trade will fail to perform its obligations under the contract. This would protect end-users of derivatives from a dealer's failure as well as guard dealers from end-users' failures. End-users should be permitted to enter into individualized credit arrangements with the financial institutions that transact on their behalf, with the option of posting noncash collateral, to meet a clearing requirement.

Fourth, the CFTC and SEC should be able to mandate robust business conduct standards to protect market integrity and lower risk. Business conduct standards should ensure, among other things, the timely and accurate confirmation, processing, netting, documentation and valuation of all transactions, as well as protect against fraud, manipulation and other abuses.

To accomplish these principal goals of promoting transparency and lowering risk, we must bring comprehensive reform to the entire OTC derivatives marketplace. Statutory exemptions can undermine that goal and, as we have seen, could leave the public exposed to unintended consequences.

Closing

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. We have a profound responsibility to address the causes of the last crisis and work to prevent the next one.

I thank you for inviting me to testify today. I look forward to working with you in the coming months to implement comprehensive reform of our financial regulatory system. I will be happy to answer any questions you may have.