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Remarks

Remarks of Chairman Gary Gensler, OTC Derivatives Reform, Fordham University College of Business Administration

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Good morning. I thank Fordham University's College of Business Administration for inviting me to speak today. The topic of this event, "The Past, Present and Future of Ethics and Regulation in the Financial Services Industry," is of significant importance as Congress and the Administration work to reform the financial regulatory system. Before I begin, I'd like to thank my 13-year-old daughter Isabel who is here with me today. I'm looking forward to taking your questions, because none of them can be as hard as hers.

The 2008 financial crisis left us with many lessons and many challenges to tackle. From addressing institutions that are too big to fail to reforming mortgage underwriting and sales practices, it is essential that the Federal Government take significant steps to prevent the next crisis. This morning, I will focus on the need for comprehensive reform of over-the-counter (OTC) derivative markets and, specifically, on the need to regulate the banks and other firms that deal in derivatives.

Derivatives are contracts used by corporations, municipalities, nonprofit organizations and others to protect themselves from the risk of a future change in markets. Every consumer is touched by corporations that use derivatives. If you flew to visit your family over the holidays, the airline most likely hedged its risk that the price of jet fuel would increase. Local fuel companies use derivatives to lock in the price of winter heating oil for their customers.

Many derivatives, called futures, are currently regulated by the Commodity Futures Trading Commission. Futures are standardized, liquid derivative contracts that have traded on exchanges since the 1860s. They allowed farmers to both hedge a future price risk and get the benefit of the price established through a national market rather than just with a local dealer. After much debate, these markets were regulated in the 1920s – more than sixty years after the first contracts were traded.

Things started to change in 1981 with the first over-the-counter derivative transaction. The early stage of this new market was highly tailored to meet hedgers' specific needs. Contracts were negotiated between a dealer and a corporation seeking to hedge a risk.

The contracts were bilateral with banks taking these contracts onto their balance sheets, assuming the risk as well as the potential profit.

In the last three decades, the over-the-counter derivatives marketplace has grown up, but it remains unregulated. From total notional amounts of less than $1 trillion in the 1980s, the notional value of this market has ballooned to more than $300 trillion in the United States – that's more than 20 times the size of the American economy; the contracts have become much more standardized; and rapid advances in technology – particularly in the last ten years – facilitate more efficient trading. While so much of this marketplace has changed significantly, the constant has been that it is still dealer-dominated.

Much like the debate after the last great crisis in the 1930s about potential regulation for both the futures and the securities markets, we are now debating whether the over-the-counter derivatives market should be regulated. While the recent crisis seems to have eased and many banks are repaying TARP money, I believe that we still must enact regulatory reform to promote transparency and reduce risk in the evolving over-the-counter derivatives markets.

Comprehensive reform of the over-the-counter derivatives marketplace must include comprehensive regulation of the derivative dealers. Leading up to the financial crisis, it was assumed that the banks that deal in derivatives were already regulated, and thus did not need to be explicitly regulated for their derivative transactions. The financial crisis demonstrated that this was a flawed assumption. While banks and securities firms were regulated by their prudential regulators, their affiliates that traded derivatives were often left ineffectively regulated – that was the case for Lehman Brothers and AIG. Even when derivatives were traded inside a regulated bank, the banks were not regulated explicitly for their derivatives trading.

Only by fully regulating the institutions that trade or hold themselves out to the public as derivative dealers can we oversee and regulate the entire derivatives market – including both standardized and customized derivatives.

First, regulators should be explicitly required to establish capital and margin requirements for all derivatives dealers. One of the lessons from the financial crisis was that banks were insufficiently prepared for the losses they could take if they were on the losing end of a derivatives transaction. In addition to helping customers hedge risk, many of the banks also were using derivatives as an off-balance sheet way to take on greater leverage and to make speculative bets on the markets. Regulators were not required to publish and enforce specific and separate capital requirements for derivatives business. Requiring banks to have sufficient capital to cover their derivatives transactions should prevent dealers from externalizing their losses to the American public in a taxpayer-funded bailout. Margin, or collateral, functions as a cushion to protect a bank's counterparties in the event that the bank cannot fulfill their end of the derivative transaction. Imposing prudent and conservative capital and margin requirements on all derivatives dealers will help prevent similar risks to the public that AIG created.

Second, dealers should be required to meet business conduct standards that both protect the integrity of the market and lower risk from over-the-counter derivatives

transactions. In the past, there was an assumption that the derivatives markets were institutional markets that did not need such protections. But derivatives are complex products, and even these markets need business conduct standards to protect against fraud, manipulation and other abuses. Such 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.

Third, derivatives dealers also should be subject to recordkeeping and reporting requirements for all of their over-the-counter derivatives transactions - including a complete audit trail and mandatory reporting of all trades. There should be clear authority for regulating and setting standards for trade repositories to ensure that the information recorded meets regulatory needs. This will provide transparency to the regulators to police the market, but more must be done to promote transparency to market participants and the public.

Fourth, dealers should be required to bring all of their standardized derivatives transactions onto transparent trading venues. Requiring banks to bring their transactions to trading venues would shift the information advantage from a small group of derivative dealers on Wall Street to the broader market. It is only Wall Street that benefits by keeping trades bilateral, where derivatives dealers internalize the transaction information. That means one corporation could get an entirely different price on a derivative than another. Wall Street profits from access to trading information while businesses, municipalities, consumers and others pay the costs. In the securities markets, this would be like putting 100 shares of a stock into your 401k with no knowledge of where the market prices the stocks. We should require that standardized derivatives be traded on regulated trading venues where all market participants get to see the pricing. Make no mistake: this is an absolutely essential component of reform.

Fifth, dealers should be required to bring their standardized derivatives transactions to regulated clearinghouses. These transactions currently stay on the books of the dealers often for years. At the same time, these banks also engage in many other businesses, such as lending, underwriting, asset management, securities trading and deposit-taking. Derivatives transactions should be moved off the books of the Wall Street banks after the trade is arranged and into regulated clearinghouses. Clearinghouses act as middlemen between two parties in an over-the-counter derivatives transaction. They require derivatives dealers to post collateral so that if one party fails, its failure does not harm its counterparties and reverberate throughout the financial system. Central clearing greatly reduces interconnectedness between Wall Street banks, their customers and the economy.

Beyond comprehensive regulatory reform of over-the-counter derivatives, the crisis also highlighted the need for other reforms that would help re-establish confidence in our financial system. In that regard, the CFTC and the Securities and Exchange Commission issued a joint report in October of last year that made twenty recommendations to enhance our authorities in the futures and securities markets. I will highlight just three of these important improvements that we are working to implement.

First, we should establish similar firewalls for commodity and futures dealers that currently exist for securities dealers. Securities regulations require the establishment of firewalls between the research, investment banking and trading branches of broker-dealers. No such firewalls are required in the commodity and futures markets. Without parallel protection, trading desks could use information developed by research arms before that information is shared with the firm's clients, raising serious questions about the integrity of the firm's services to its clients and confidence in the markets.

Second, any person that offers investment advice to customers should be governed by the same fiduciary standard. Currently, broker-dealers, investment advisors and commodity trading advisors are all subject to different standards, even though they perform the same function – to deliver investment advice. We have recommended that there be a uniform standard that financial advice should be solely in the interest of the customer, without regard to the advisor's own financial interests.

Finally, we have recommended banning using misappropriated government information to trade in the commodity markets. Many of you in this audience may have seen the movie "Trading Places," starring Eddie Murphy. In the movie, the Duke brothers intend to profit from trades in frozen orange juice futures using an illicitly obtained and not yet public Department of Agriculture orange crop report. Characters played by Eddie Murphy and Dan Aykroyd intercept the misappropriated report and trade on it to profit and ruin the Duke brothers. In real life, using such misappropriated government information actually is not illegal under our statute. To prevent misappropriation and misuse of such information, we have recommended what we call the "Eddie Murphy" rule to ban insider trading using nonpublic information acquired from a government source.

In 2008, we watched the financial system fail. The financial crisis reminded us of the great challenges facing our economy. It is essential that we bring regulatory reform to the derivatives markets to best protect the American public.

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