



## Commodity Futures Trading Commission

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# Testimony

## Testimony of Chairman Gary Gensler Before the House Committee on Agriculture

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Good morning Chairman Peterson, Ranking Member Lucas and members of the Committee. Thank you for inviting me to testify today about financial regulatory reform. This Committee has recently moved historic legislation to comprehensively regulate over-the-counter (OTC) derivatives. Today, you requested that I address other aspects of reform. Specifically, I will address how those proposals might intersect with the Commodity Futures Trading Commission's (CFTC) oversight of markets. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC).

This morning's hearing falls on the anniversary of a significant date in our nation's history. On November 17<sup>th</sup>, 1800, the United States Congress held its first session in Washington, D.C. in the partially completed Capitol Building. More than two centuries ago, this body convened to address a great many challenges facing a young nation. We now face a new set of challenges as the nation continues to recover from last year's failure of the financial system and the financial regulatory system. We must work to ensure that we do not again face a similar crisis.

Last year's financial crisis taught us that American and global financial institutions had not only become what some called too big to fail, but also too interconnected to fail. Institutions have become so large and so intertwined with each other and the rest of the financial system that the government was forced to make untenable decisions last year. Effective regulatory reform requires mechanisms to handle firms whose failure could threaten the integrity of the entire financial system.

To address these risks, the Administration has proposed that we fill gaps in our financial regulatory structure, and most importantly, over-the-counter derivatives. I commend this Committee, as well as the House Financial Services Committee, for taking historic action last month to, for the first time, introduce regulation to the OTC markets.

OTC derivatives reform is just one important piece of the Administration's broader financial reform proposals, which address many of the lessons learned from last year's crisis. You have asked me to focus my testimony today on this issue as well as two

other critical features to lower the risk to the American public presented by large financial institutions. The Administration has outlined two fundamental goals: establishing comprehensive, consolidated supervision of financial firms and establishing a resolution regime to wind down large, complex financial institutions that are on the brink of failure.

### **Over-The-Counter Derivatives**

I believe that comprehensive OTC derivatives reform is a critical component of addressing the risks posed by large financial institutions. These institutions have become interconnected with literally thousands of counterparties located in every sector of our economy and in every state in our nation. The historic legislation passed by this Committee and the Financial Services Committee does this by comprehensively regulating the dealers, by requiring standard contracts to be traded on transparent trading venues and by moving the standard transactions off the books of financial institutions and into regulated clearinghouses. This would remove the transactions, once arranged, from the balance sheets of large financial firms, limiting the effect that one firm's failure could have on the system.

Building upon these critical features of the bill, I am hopeful that we can clarify exceptions such that all standard contracts are brought to transparent trade execution facilities even if Congress were to allow for exceptions from clearing requirements. Further, I am hopeful any exceptions from clearing would be narrowly limited to corporate end-users.

### **Consolidated Supervision**

Another gap in our financial regulatory system relates to consolidated comprehensive supervision and regulation of major financial firms that could pose a risk to the financial system. Under the Bank Holding Company Act, passed in the 1950s, the Federal Reserve has supervisory authority over a bank holding company, but no effective federal regulation exists for complex financial institutions that do not have a bank subsidiary. This left ineffective or even no federal oversight of investment banking holding companies, insurance holding companies and other financial conglomerates. Also, even in the context of bank holding companies, the coordination and authority of the Federal Reserve, as the holding company regulator, in relation to other regulators overseeing particular subsidiaries needs to be enhanced.

The Administration and Congressional proposals address these issues by creating an overall prudential regulatory scheme for complex financial firms. This would ensure that one regulator, working in coordination with other regulators, could set capital, liquidity, risk management and other prudential standards for major financial firms. This would include setting standards for subsidiaries that otherwise are not subject to prudential regulation, as well as working with the primary regulators of subsidiaries that are currently regulated.

### **Resolution Authority**

Another lesson of the financial crisis is that the Federal Government needs more flexible tools to wind down major financial firms without causing significant harm to the financial

system as a whole or the economy. A successful financial regulatory system must provide for the orderly resolution of complex financial firms in a manner that mitigates the risk that one institution's collapse could cause the failure of other institutions. As the experience with Lehman Brothers showed, resolving such firms through the bankruptcy process can cause significant economic disruption and displacement. Results may differ from one jurisdiction to another, and the process may be cumbersome and unresponsive to the need to resolve an institution rapidly in the public interest.

Under current law, the Federal Deposit Insurance Corporation (FDIC) has the ability to step in and put a bank into receivership when it is about to fail. This allows them to step in as management, to modify contracts and to oversee the orderly resolution of the banks to best lower costs to taxpayers. The government, however, was limited in its ability to use similar resolution authorities at the holding company level or for financial institutions that were not banks. Such limitation was starkly evident when even \$180 billion of our taxpayer dollars sent to AIG did not enable the government to modify contracts with AIG's counterparties or with their senior executives for compensation. In the case of AIG, counterparties were not required to take a haircut and many senior executives argued that their contracts should remain unaltered. Thus, the Administration and Congressional proposals seek to broaden the FDIC's resolution authority to include both the entire holding company of a bank as well as major financial firms that could pose a risk to the entire financial system

### **Implications for CFTC-Regulation**

In inviting me to testify here today, you have asked us to address how broader financial reform proposals interplay with the Commodity Exchange Act and the Commission's existing authorities. In that regard, I will outline three areas on which this Committee may want to focus as it further considers these proposals.

### **Inclusion of Exchanges and Clearinghouses under Consolidated Supervision**

Under the proposed regime of consolidated comprehensive supervision, certain financial companies would be designated as "identified financial holding companies." The companies could become subject to heightened prudential standards set by the Federal Reserve Board. The Federal Reserve would be required by statute to set standards for such companies in the following areas: risk-based capital requirements; leverage limits; liquidity requirements; concentration requirements; prompt corrective action; resolution plans; and overall risk management.

The Federal Reserve Board's prudential supervision also would extend to the identified financial holding company's affiliates and subsidiaries. This would include intermediaries registered with the CFTC, such as futures commission merchants (FCMs), commodity pool operators (CPOs) or other intermediaries. The statute authorizes the Federal Reserve to prescribe heightened prudential standards for such subsidiaries. If the regulatory agency declines to implement the recommended standards, the statute authorizes the Federal Reserve to directly implement the heightened prudential standards.

While seeking to address the gaps and inconsistencies that exist in the current regulatory structure of complex, consolidated financial firms, the proposals also may

have unintentionally encompassed robustly regulated markets such as securities and futures exchanges. While it does not appear that the intent of the legislation is to capture these entities, exchange companies nevertheless may be included as they are organized under holding companies and may meet a broad definition of financial company. As these holding companies and their subsidiaries, such as the New York Stock Exchange or the Chicago Mercantile Exchange, are currently comprehensively regulated by the Securities and Exchange Commission (SEC) and the CFTC, Congress may wish to clarify if they should be included in the Federal Reserve's prudential supervisory authority over holding companies.

## **Supervision of Financial Activities**

The Administration and Congressional proposals include a new financial Services Oversight Council, which would include the heads of various Federal regulators. While the responsibilities and authorities of such a Council vary amongst the proposals, one of the proposed duties is to designate identified financial holding companies that would be subject to heightened prudential standards. In addition, some proposals recommend that the Council also identify activities or practices that the Council or the Federal Reserve would be authorized to subject to heightened prudential standards.

Such financial activity or practice could apply to a broad range of market activities, many of which are currently regulated by the SEC and the CFTC. If the SEC or the CFTC declined to implement the Federal Reserve's recommended standard, the Federal Reserve would have authority to directly implement its own recommendations.

Much of what the CFTC and SEC currently oversee in the financial markets could be determined by the Council to be systemically relevant. Thus, proposals to have a Council and the Federal Reserve involved as just described has the potential of setting up multiple regulators overseeing markets and market functions in the United States. While it is important to enhance the oversight of markets by both the SEC and CFTC, I think Congress would want to closely consider whether it's best to set up multiple regulators for some functions.

## **Regulation of Payment and Clearing Systems**

Administration and Congressional proposals also address oversight of payment and clearing systems. Currently, clearing organizations for futures and securities are overseen by the market regulators: the CFTC and the SEC. With respect to wholesale inter-bank payment and settlement systems, the Federal Reserve relies on a patchwork of authorities, largely derived from its role as a banking supervisor to help oversee them. There is no explicit statutory basis, however, for the Federal Reserve's oversight of these payment and settlement systems, and there is no uniform regulatory structure. It is important for reform to address such gaps in the regulatory structure.

Under the historic derivatives legislation passed by this Committee, important enhancements to the CFTC's oversight of clearing organizations were included, both for futures and OTC derivatives. These provisions clarify the Commission's ability to regulate clearinghouses, write rules and oversee the setting of margin to protect the financial integrity of clearinghouses. The bill also strengthened the core principles to bring them up to international standards. I believe that these are all important

enhancements so that the CFTC can robustly regulate risk management and other aspects of futures and OTC clearinghouses.

The broader financial reform proposals importantly address a gap in oversight of payment systems by giving statutory authority to the Federal Reserve to oversee interbank payment systems. The proposals, however, go further by also authorizing the Federal Reserve to effectively regulate securities, futures and derivatives clearinghouses. The Federal Reserve would be able to set standards and review and approve rules to address risk management policies and procedures, margin and collateral requirements, counterparty default policies and procedures, timely clearing and settlement of transactions, capital and financial resource requirements.

In addition to prescribing standards, the Federal Reserve would have the authority to directly participate in examinations, make recommendations for enforcement and implement those recommendations in certain circumstances. Thus, the proposals may effectively set up a system of dual regulation of clearinghouses between the market regulators on the one hand and the Federal Reserve on the other.

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 clearinghouses for that market should continue as we extend regulations to cover the OTC derivatives market. Market regulation of clearing, customer protection, segregation rules, trading venues and other components are so closely intertwined that Congress has for decades had them regulated by single regulators – either the CFTC or the SEC. Furthermore, Congress has stated expressly that the purpose of the Commodity Exchange Act is to ensure the financial integrity of all transactions subject to the CFTC's jurisdiction and the avoidance of systemic risk.

### **Additional Items**

In addition to the three areas that I have outlined above, since I last testified before this Commission, the CFTC and the SEC announced 20 joint recommendations to tailor our regulations in the best interest of the American public. I look forward to working with this Committee and Congress on a number of these proposals that will require changes in statute. One important proposal is to establish a more efficient process for the SEC and CFTC product approval, including an ability to resolve any differences by referring such instances to the full Commissions and, if necessary, a Federal court of appeals. While the various regulatory reform proposals designate the Council as the arbitrator of an interagency dispute involving products, among other things, I believe that our joint recommendation is a preferred approach.

Lastly, one aspect of the proposed resolution authority may cause an unintended consequence when applied to a financial company that is a member of a derivatives or securities clearing organization. The resolution authority provisions provide for the suspension of contract obligations for entities under receivership. This means that obligations of clearing members would be suspended until 5 PM on the business day after a receiver is appointed. Suspending a clearing member's obligations, even for a

day, would preclude a derivatives or securities clearing organization from liquidating a clearing member's contracts during that time. Collateral that might have been sufficient to fund an immediate close-out might then be inadequate to cover the losses of a delayed close-out, particularly in the case of a financial institution whose failure has system wide effects.

## **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. On the 209<sup>th</sup> anniversary of the first session of Congress in the new Capitol building, 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.