

20091118 CFTC: Testimony of Gary Gensler, CFTC Chairman, before the Senate Committee on Agriculture

US Commodities Futures Trading Commission

Good morning Chairman Lincoln, Ranking Member Chambliss and members of the Committee. Thank you for inviting me to testify today regarding the regulation of over-the-counter derivatives. I also will provide this Committee with an update on our joint efforts with the Securities and Exchange Commission (SEC) to tailor our regulations in the best interest of the American public. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC).

Since I last testified before this Committee, the gavel was passed from Senator Harkin to Chairman Lincoln. I would like to thank Senator Harkin for his leadership and congratulate Chairman Lincoln. I look forward to continuing to work with both Senators as well as the Committee and Congress on necessary reform.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public. Exhibit A of these twin failures was the collapse of AIG. Every single taxpayer in this room – both the members of this Committee and the audience – put money into a company that most Americans had never even heard of. Approximately \$180 billion of our tax dollars went into AIG – that is more than \$3.5 billion per each of your states. 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.

I would like to address much-needed regulatory reform of OTC derivatives in the context of two principal goals: promoting transparency of the markets and lowering risk to the American public.

We embark upon this reform effort as the financial industry has become ever more concentrated. Given the events of the last decade, there are fewer providers of financial services today. There may be 15 to 20 large complex financial institutions that are at the center of today's global derivatives marketplace. Five to ten years from now, it is quite possible that the financial system will become even more concentrated. With fewer actors on the stage, it is especially important that we lower the risk of these participants and bring sunshine to the activities in which they are involved.

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 relatively new marketplace for OTC derivatives.

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, the Administration has proposed – and I fully support – the following priorities:

First, all standardized OTC derivative transactions should be moved onto regulated transparent exchanges or trade execution facilities. I believe that this is the only way that we can best address information deficits for market participants. Such transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the OTC swaps 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. A municipality, for example, could better decide whether or not to hedge an interest rate risk based upon the reported pricing from exchanges. As customized products often are priced in relation to standardized products, I believe that mandated trading through transparent trading venues will 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, I believe that all standard contracts should be brought to transparent trade execution facilities.

Second, all non-cleared transactions 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, the Administration proposed – and I support – four essential components of reform.

First, standard OTC transactions should be required to be cleared by robustly regulated central counterparties. By guaranteeing the performance of contracts submitted for clearing, the clearing process significantly reduces systemic risks. 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. Right now, however, 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.

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 interconnectedness from the 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. I believe that 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 that have such tremendous promise for the responsible management of financial risk. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system.

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 jurisdictions. This well-established practice of having the agency that 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.

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, I believe that 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.

Working with the SEC

Comprehensive regulation of OTC derivatives will require ongoing cooperation between the CFTC and the SEC. Last month, the two agencies jointly announced 20 recommendations for improvements to regulations and statute to best protect the American public. Of the recommendations, eleven relating to the CFTC require legislation. Of these eleven, three are part of the Administration's proposal on OTC derivatives, and one, which seeks the creation of a joint advisory committee on emerging regulatory issues, is currently before the House and Senate Appropriations Committees. We will provide language to this Committee and others on the remaining recommendations.

First, the Administration's proposal includes enhancements to the CFTC's oversight of clearing organizations, 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 proposal also strengthens the core principles to bring them up to international standards.

Second, the Administration's proposal includes amendments to the CEA that would authorize the CFTC to require registration of any foreign board of trade that seeks to provide direct access to market participants located in the United States and, when appropriate, cooperate with foreign regulators to avoid duplicative regulation.

Third, the Administration proposal contains provisions creating a firewall between analysts and trading functions within intermediaries. This is similar to rules governing conflicts of interest at broker-dealers under existing securities laws.

The CFTC and SEC also have jointly recommended that Congress act in the following areas: first, legislation should be enacted to enhance the CFTC's enforcement authorities with respect to manipulative practices that undermine market integrity and the price formation process in the futures markets. Experience shows that certain practices are so disruptive to trading in the futures markets that they should be presumptively prohibited in statute.

Second, we have recommended expanding existing opportunities for portfolio margining, which is important to U.S. competitiveness. The agencies are now working together to recommend legislative language that would facilitate the holding of securities and futures in a single account, whether it be a securities or a futures portfolio margin account. The legislation also would address protection of customer accounts if the broker-dealer or futures commission merchant becomes insolvent.

Third, we have recommended establishing legal certainty with respect to product listings. The CFTC and SEC are working on legislative language that would clarify their exemptive authority and would outline a review process to ensure that any jurisdictional dispute is resolved by the Commissions – not staff – against a firm timeline. Should the Commissions fail to resolve the dispute within the strict timeline, the matter would be referred to a federal court of appeals.

Fourth, we have recommended that all intermediaries that provide investment advisory services, whether regulated by the CFTC or by the SEC, should be subject to uniform fiduciary duty standards. Commodity trading advisors, commodity pool operators and introducing brokers should

be subject to the same standards as broker-dealers or investment advisors when performing the same advisory functions. Robust customer protection should apply equally across the securities and futures markets.

Fifth, we have recommended that Congress consider legislation to encourage whistleblowers to come forward with relevant information to authorities in both SEC and CFTC registered markets.

Sixth, legislation should clarify that restitution should be calculated to fully compensate victims for their lost investment. This would address future uncertainty related to an appellate court decision that measured restitution as the gain to the defendant, rather than trading losses suffered by victims.

Finally, we have recommended legislation to expand the scope of insider trading coverage under the CEA. Currently, for example, misuse of material non-public information from government agencies other than the CFTC is not punishable. The CEA should be amended to make unlawful the misappropriation and trading on the basis of material non-public information from any governmental authority. We loosely call this the Eddie Murphy rule given the role he played in the movie "Trading Places."

The CFTC will continue to work closely with the SEC and Congress to enact these significant enhancements to our regulatory oversight.

Closing

I look forward to working with the Congress and other federal regulators to apply comprehensive regulation to the OTC derivatives marketplace and to secure additional resources so that the CFTC can effectively regulate the markets. The United States thrives in a regulated market economy. This requires innovation and competition, but also regulation, to ensure that our markets are fair and orderly. We have a tough job ahead of us, but it is essential that we get it done to protect the American public.

I thank you for inviting me to testify today. I am happy to answer any questions you may have.

NovaRes Team