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Testimony

Testimony of Chairman Gary Gensler Commodity Futures Trading Commission Before the House Financial Services Committee

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Good morning Chairman Frank, Ranking Member Bachus, and Members of the Committee. I am here today testifying on behalf of the Commission.

Financial regulatory reform is critical for the health of our economy. As President Obama outlined last month, we must urgently enact broad reforms in our financial regulatory structure in order to rebuild and restore confidence in our financial system.

Such reforms must comprehensively regulate both derivative dealers and the markets in which derivatives trade. I look forward to working with the Congress to ensure that all derivatives markets are transparent and free from fraud, manipulation and other abuses.

This effort will require close coordination between the SEC and the CFTC to ensure the most appropriate regulation. I'm fortunate to have as a partner in this effort, SEC Chair Mary Shapiro. She brings invaluable expertise in both the security and commodity futures area, which gives me great confidence that we will be able to provide the Congress with a sound recommendation for comprehensive oversight of the OTC derivatives market. We also will work collaboratively on recommendations on how to best harmonize regulatory efforts between agencies as requested by President Obama.

Comprehensive Regulatory Framework

A comprehensive regulatory framework governing OTC derivative dealers and OTC derivative markets should apply to all dealers and all derivatives, no matter what type of derivative is traded or marketed. It should include interest rate swaps, currency swaps, commodity swaps, credit default swaps, and equity swaps. Further, it should apply to dealers and derivatives no matter what type of swaps or other derivatives may be invented in the future. This framework should apply regardless of whether the derivatives are standardized or customized.

A new regulatory framework for OTC derivatives markets should be designed to achieve four key objectives:

- Lower systemic risks;
- Promote the transparency and efficiency of markets;
- Promote market integrity by preventing fraud, manipulation, and other market abuses, and by setting position limits; and
- Protect the public from improper marketing practices.

To best achieve these objectives, two complementary regulatory regimes must be implemented: one focused on the dealers that make the markets in derivatives and one focused on the markets themselves – including regulated exchanges, electronic trading systems and clearing houses. Only with these two complementary regimes will we ensure that federal regulators have full authority to bring transparency to the OTC derivatives world and to prevent fraud, manipulation, and other types of market abuses. These two regimes should apply no matter which type of firm, method of trading or type of derivative or swap is involved.

Regulating Derivatives Dealers

I believe that institutions that deal in derivatives must be explicitly regulated. In addition, regulations should cover any other firms engaged in derivatives whose activities in these markets can create large exposures to counterparties.

The current financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system and that all such firms should be subject to robust Federal regulation. The AIG subsidiary that dealt in derivatives – AIG Financial Products – for example, was not subject to any effective regulation. The derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks were not subject to mandatory regulation either.

By fully regulating the institutions that trade or hold themselves out to the public as derivative dealers we can oversee and regulate the entire derivatives market. I believe that our laws should be amended to provide for the registration and regulation of all derivative dealers.

The full, mandatory regulation of all derivatives dealers would represent a dramatic change from the current statutory system in which some dealers can operate with limited or no effective oversight. Specifically, all derivative dealers should be subject to capital requirements, margining requirements, business conduct rules and reporting and recordkeeping requirements. Standards that already apply to some dealers, such as banking entities, should be strengthened and made consistent, regardless of the legal entity where the trading takes place.

Capital and Margin Requirements. Congress should explicitly require regulators to promulgate capital requirements for all derivatives dealers, and margin requirements for all derivatives dealers. Imposing prudent and conservative capital and margin requirements on all derivatives dealers will help prevent the types of systemic risks that AIG created. No longer would derivatives dealers or counterparties be able to amass large or highly leveraged risks outside the oversight and prudential safeguards of regulators.

Congress should also consider explicitly authorize regulators to require derivatives dealers and counterparties to segregate, or set aside, from their own funds, the margin required. This segregation or set-aside requirement will help ensure that counterparties are protected, if either counterparty to the customized OTC transaction experiences financial difficulties.

Also, Congress should consider amending the Bankruptcy Code to ensure that, if a derivatives dealer or counterparty of a customized OTC transaction that is not cleared becomes insolvent, either party can make themselves whole by accessing margin, and can continue economic activity without major disruption by moving positions to another derivatives dealer.

Imposing segregation requirements, and making relevant amendments to the Bankruptcy Code, will help prevent the failure of one derivatives dealer or counterparty to a customized OTC transaction that is not cleared from jeopardizing other parties. Appropriate segregation or set-aside requirements and bankruptcy protections should be developed for both standardized and cleared and or customized and not cleared OTC transactions.

Business Conduct and Transparency Requirements. Business conduct standards should include measures to both protect the integrity of the market and lower the risk (both counterparty and operating) from OTC derivatives transactions.

To promote market integrity, the business conduct standards should include prohibitions on fraud, manipulation and other abusive practices. For OTC derivatives that come under CFTC jurisdiction, these standards should require adherence to position limits when they perform or affect a significant price discovery function with respect to regulated markets.

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.

Derivatives dealers also should be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements should include retaining a complete audit trail and mandated reporting of any trades that are not centrally cleared to a regulated trade repository. Trade repositories complement central clearing by providing a location where trades that are not centrally cleared can be recorded in a manner that allows the positions, transactions, and risks associated with those trades to be reported to regulators. To provide transparency of the entire OTC derivatives market, this information should be available to all relevant federal financial regulators. Additionally, there should be clear authority for regulating and setting standards for trade repositories and clearinghouses to ensure that the information recorded meets regulatory needs and that the repositories have strong business conduct practices.

The application of these business conduct standards and the transparency requirements will enable regulators to have timely and accurate knowledge of the risks and positions created by the dealers. It will provide authorities with the information and evidentiary record needed to take any appropriate action to address such risks and to protect and police market integrity. In this regard, the CFTC and SEC should have clear, unimpeded oversight and enforcement authority to prevent and punish fraud, manipulation and other market abuses.

Market transparency should be further enhanced by requiring that aggregated information on positions and trades be made available to the public. No longer should the public be in the dark about the extensive positions and trading in these markets. This public information will improve the price discovery process and market efficiency.

Regulating Derivatives Markets

In addition to the significant benefits to be gained from broad regulation of derivatives dealers, I believe that additional safety and transparency must be afforded by regulating derivative market functions as well. All derivatives that can be moved into central clearing should be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems.

Requiring clearing and trading on exchanges or through regulated electronic trading systems will promote transparency and market integrity and lower systemic risks. To fully achieve these objectives, both of these complementary regimes must be enacted. Regulating both the traders and the trades will ensure that both the actors and the actions that may create significant risks are covered.

Exchange-trading and central clearing are the two key and related components of well-functioning markets. 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. The practice of having the agency which regulates an exchange or trade execution facility also regulate the clearing houses for that market has worked well and should continue as we extend regulations to cover the OTC derivatives market.

Central Clearing. Central clearing should help reduce systemic risks in addition to the benefits derived from comprehensive regulation of derivatives dealers.

Clearing reduces risks by facilitating the netting of transactions and by mutualizing credit risks. Currently, most of the contracts entered into in the OTC derivatives market are not cleared, and remain as bilateral contracts between individual buyers and sellers. In contrast, when a contract between a buyer and seller is submitted to a clearinghouse for clearing, the contract is “novated” to the clearinghouse. This means that the clearinghouse is substituted as the counterparty to the contract and then stands between the buyer and the seller.

Clearinghouses then guarantee the performance of each trade that is submitted for clearing. Clearinghouses use a variety of risk management practices to assure the fulfillment of this guarantee function. Foremost, derivatives clearinghouses lower risk through the daily discipline of marking to market the value of each transaction. They also require the daily posting of margin to cover the daily changes in the value of positions and collect margin as extra protection against potential market changes that are not covered by the daily mark-to-market.

The regulations applicable to clearing should require that clearinghouses establish and maintain robust margin standards and other necessary risk controls and measures. It is important that we incorporate the lessons from the current crisis as well as the best practices reflected in international standards. Working with Congress, we should consider possible amendments to the CEA to expand and deepen the core principles that registered derivatives clearing organizations must meet to achieve these goals to both strengthen these systems and to reduce the possibility of regulatory arbitrage. Clearinghouses should have transparent governance arrangements that incorporate a broad range of viewpoints from members and other market participants.

Central counterparties should also be required to have fair and open access criteria that allow any firm that meets objective, prudent standards to participate regardless of whether it is a dealer or a trading firm. Additionally, central clearinghouses should implement rules that allow indirect participation in central clearing. By novating contracts to a central clearinghouse coupled with effective risk management practices, the failure of a single trader, like AIG, would no longer jeopardize all of the counterparties to its trades.

One of the lessons that emerged from this recent crisis was that institutions were not just "too big to fail," but rather too interconnected as well. By mandating the use of central clearinghouses, institutions would become much less interconnected, mitigating risk and increasing transparency. Throughout this entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses continued to be cleared and settled.

In implementing new responsibilities for CCPs clearing swaps, it will be appropriate to consider possible additional oversight requirements that may be imposed by any systemic risk regulator that Congress may establish.

Under the Administration's approach, the systemic regulator would be charged with ensuring consistent and robust standards for all systemically important clearing, settlement and payment systems. For clearinghouses overseen comprehensively by the CFTC and SEC, the CFTC or SEC would remain the primary regulatory, but the systemic regulator would be able to request information from the primary regulator, participate in examinations led by the primary regulator, make recommendations on strengthening standards to the primary regulator and ultimately, after consulting with the primary regulator and the new Financial Services Oversight Council, use emergency authority to compel a clearinghouse to take actions to address financial risks.

Requiring clearing for standard products will promote market integrity and lower risk. Individual firms will become less interconnected as OTC transactions are netted out through centralized clearing. Furthermore, mandated clearing will bring the discipline of daily valuation of transactions and the posting of collateral.

Exchange-trading. Beyond the significant transparency afforded the regulators and the public through the record keeping and reporting requirements of derivatives dealers, market transparency and efficiency would be further improved by moving the standardized part of the OTC markets onto regulated exchanges and regulated transparent electronic trading systems. I believe that this should be required of all standardized contracts.

Furthermore, a system for the timely reporting of trades and prompt dissemination of prices and other trade information to the public should be required. Both regulated exchanges and regulated transparent trading systems should allow market participants to see all of the bids and offers. A complete audit trail of all transactions on the exchanges or trade execution systems should be available to the regulators. Through a trade reporting system there should be timely public posting of the price, volume and key terms of completed transactions. The Trade Reporting and Compliance Engine (TRACE) system currently required for timely reporting in the OTC corporate bond market may provide a model.

The CFTC and SEC also should have authority to impose recordkeeping and reporting requirements and to police the operations of all exchanges and electronic trading systems to prevent fraud, manipulation and other abuses.

In contrast to long established on-exchange futures and securities markets, there is a need to encourage the further development of exchanges and electronic trading systems for OTC derivatives. In order to promote this goal and achieve market efficiency through competition, there should be sufficient product standardization so OTC derivative trades and open positions are fungible and can be transferred between one exchange or electronic trading system to another.

Position Limits. Position limits must be applied consistently across all markets, across all trading platforms, and exemptions to them must be limited and well defined. The CFTC should have the ability to impose position limits, including aggregate limits, on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets that the CFTC oversees. Such position limit authority should clearly empower the CFTC to establish aggregate position limits across markets in order to ensure that traders are not able to avoid position limits in a market by moving to a related exchange or market, including international markets.

Standardized and Customized Derivatives

It is important that tailored or customized swaps that are not able to be cleared or traded on an exchange be sufficiently regulated. Regulations should ensure that customized derivatives are not used solely as a means to avoid the clearing and exchange requirements. This could be accomplished in two ways. First, regulators should be given full authority to prevent fraud, manipulation and other abuses and to impose recordkeeping and transparency requirements with respect to the trading of all swaps, including customized swaps. Second, we must ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems.

One way to ensure this would be to establish objective criteria for regulators to determine whether, in fact, a swap is standardized. For example, there should be a presumption that if an instrument is accepted for clearing by a fully regulated clearinghouse, then it should be required to be cleared. Additional potential criteria for consideration in determining whether a contract should be considered to be a standardized swap contract could include:

- The volume of transactions in the contract;
- The similarity of the terms in the contract to terms in standardized contracts;
- Whether any differences in terms from a standardized contract are of economic significance; and
- The extent to which any of the terms in the contract, including price, are disseminated to third parties.

Criteria such as these could be helpful in ensuring that parties are not able to avoid the requirements applicable to standardized contracts by tweaking the terms of such contracts and then labeling them "customized."

Regardless of whether an instrument is standardized or customized, or traded on an exchange or on a transparent electronic trade execution system, regulators should have clear, unimpeded authority to impose recordkeeping and reporting requirements, impose margin requirements, and prevent and punish fraud, manipulation and other market abuses. No matter how the instrument is traded, the CFTC and SEC as appropriate also should have clear, unimpeded authority to impose position limits, including aggregate limits, to prevent excessive speculation. A full audit trail should be available to the CFTC, SEC and other Federal regulators. **Authority**

To achieve these goals, the Commodity Exchange Act and securities laws should be amended to provide the CFTC and SEC with clear authority to regulate OTC derivatives. The term "OTC derivative" should be defined, and clear authority should be given over all such instruments regardless of the regulatory agency. To the extent that specific types of OTC derivatives might overlap agencies' existing jurisdiction, care must be taken to avoid unnecessary duplication.

As we enact new laws and regulations, we should be careful not to call into question the enforceability of existing OTC derivatives contracts. New legislation and regulations should not provide excuses for traders to avoid performance under pre-existing, valid agreements or to nullify pre-existing contractual obligations.

Achieving the Four Key Objectives

Overall, I believe the complimentary regimes of dealer and market regulation would best achieve the four objectives outlined earlier. As a summary, let me review how this would accomplish the measures applied to both the derivative dealers and the derivative markets.

Lower Systemic Risk. This dual regime would lower systemic risk through the following four measures:

- Setting capital requirements for derivative dealers;
- Establishing margin requirements for derivative dealers (whether dealing in standardized or customized swaps);
- Establishing segregation or set aside requirements for derivatives dealers and counterparties to customized OTC transactions, and creating appropriate bankruptcy protections;
- Requiring centralized clearing of standardized swaps; and
- Requiring business conduct standards for dealers.

Promote Market Transparency and Efficiency. This complementary regime would promote market transparency and efficiency by:

- Requiring that all OTC transactions, both standardized and customized, be reported to a regulated trade repository or central clearinghouses;
- Requiring clearinghouses and trade repositories to make aggregate data on open positions and trading volumes available to the public;
- Requiring clearinghouses and trade repositories to make data on any individual counterparty's trades and positions available on a confidential basis to regulators;
- Requiring centralized clearing of standardized swaps;
- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and
- Requiring the timely reporting of trades and prompt dissemination of prices and other trade information;

Promote Market Integrity. It would promote market integrity by:

- Providing regulators with clear, unimpeded authority to impose reporting requirements and to prevent fraud, manipulation and other types of market abuses;
- Providing regulators with authority to set position limits, including aggregate position limits;

- Moving standardized products onto regulated exchanges and regulated, transparent trade execution systems; and

- Requiring business conduct standards for dealers.

Protect Against Improper Marketing Practices. It would ensure protection of the public from improper marketing practices by:

- Business conduct standards applied to derivatives dealers regardless of the type of instrument involved; and

- Amending the limitations on participating in the OTC derivatives market in current law to tighten them or to impose additional disclosure requirements, or standards of care (e.g. suitability or know your customer requirements) with respect to marketing of derivatives to institutions that infrequently trade in derivatives, such as small municipalities.

Conclusion

The need for reform of our financial system today has many similarities to the situation facing the country in the 1930s. In 1934, President Roosevelt boldly proposed to the Congress “the enactment of legislation providing for the regulation by the Federal Government of the operation of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.” The Congress swiftly responded to the clear need for reform by enacting the Securities Exchange Act of 1934. Two years later it passed the Commodity Exchange Act of 1936.

It is clear that we need the same type of comprehensive regulatory reform today. Today’s regulatory reform package should cover all types of OTC derivatives dealers and markets. It should provide regulators with full authority regarding OTC derivatives to lower risk; promote transparency, efficiency, and market integrity and to protect the American public.

Finally, I would note that we are working closely with our international partners to make sure that the legislative, regulatory and policy developments outlined today occur in tandem with our international partners. We are therefore working closely with our colleagues in Europe and Asia on areas of particular concern in order to try to prevent regulatory arbitrage.

Today’s complex financial markets are global and irreversibly interlinked. We must work with our partners in regulating markets around the world to promote consistent rigor in enforcing standards that we demand of our markets.

I look forward to working with this Committee, and others in Congress, to accomplish these goals.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I look forward to answering any questions.