TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

WASHINGTON, DC

June 16, 2011

Good morning Chairman Bachus, Ranking Member Frank and members of the Committee. I thank you for inviting me to today's hearing on the international context of financial regulatory reform. I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation.

I am pleased to testify alongside my fellow regulators.

Global Crisis

It has now been more than two years since the financial crisis, when both the financial system and the financial regulatory system failed. So many people – not just in the United States, but throughout the world – who never had any connection to derivatives or exotic financial contracts had their lives hurt by the risks taken by financial actors. The effects of the crisis remain. All over the world, we still have high unemployment, homes that are worth less than their mortgages and pension funds that have not regained the value they had before the crisis. We still have significant uncertainty in the financial system.

Though the crisis had many causes, it is clear that the swaps market played a central role. Swaps added leverage to the financial system with more risk being backed up by less capital. They contributed, particularly through credit default swaps, to the bubble in the housing market and helped to accelerate the financial crisis. They contributed to a system where large financial institutions were thought to be not only too big to fail, but too interconnected to fail. Swaps – initially developed to help manage and lower risk – actually concentrated and heightened risk in the economy and to the public.

At the conclusion of the September 2009 G-20 summit held in Pittsburgh, leaders of 19 nations and the European Union concurred that "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

We now are working across borders to achieve that goal.

Derivatives Markets

Each part of our nation's economy relies on a well-functioning derivatives marketplace. The derivatives market – including both the historically regulated futures market and the heretofore unregulated swaps market – is essential so that producers, merchants and other end-users can manage their risks and lock in prices for the future. Derivatives help these entities focus on what they know best – innovation, investment and producing goods and services – while finding others in a marketplace willing to bear the uncertain risks of changes in prices or rates.

With notional values of approximately $300 trillion in the United States – that's more than $20 of swaps for every dollar of goods and services produced in the U.S. economy – and approximately $600 trillion worldwide, derivatives markets must work for the benefit of the public. Members of the public keep their savings with banks and pension funds that use swaps to manage their interest rate risks. The public buys gasoline and groceries from companies that rely upon futures and swaps to hedge their commodity price risks.

That's why international oversight must ensure that these markets function with integrity, transparency, openness and competition, free from fraud, manipulation and other abuses. Though the CFTC is not a price-setting agency, recent volatility in prices for basic commodities – agricultural and energy – are very real reminders of the need for common sense rules in the derivatives markets.

International Coordination

To address changes in the derivatives markets as well as the real weaknesses in swaps market oversight exposed by the financial crisis, the CFTC is working to implement the Dodd-

Frank Wall Street Reform and Consumer Protection Act’s derivatives oversight reforms. Our international counterparts also are working to implement reform.

Japan has acted and is now working to implement its reforms. In September of last year, the European Commission (E.C.) released its swaps proposal. The European Council and the European Parliament are now considering the proposal. Asian nations, as well as Canada, also are working on their reform packages.

As we work to implement the derivatives reforms in the Dodd-Frank Act, we are actively coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC co-chairs with the Securities and Exchange Commission (SEC). The CFTC, SEC, European Commission and European Securities Market Authority are intensifying discussions through a technical working group.

As we do with domestic regulators, we are sharing many of our memos, term sheets and draft work product with international regulators. We have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the UK Financial Services Authority, the new European Securities and Markets Authority, the Japanese Financial Services authority and regulators in Canada, France, Germany and Switzerland. Two weeks ago, I met with Michel Barnier, the European Commissioner for Internal Market and Services, to discuss ensuring consistency in swaps market regulation.

The Dodd-Frank Act recognizes that the swaps market is global and interconnected. It gives the CFTC the flexibility to recognize foreign regulatory frameworks that are comprehensive and comparable to U.S. oversight of the swaps markets in certain areas. In addition, we have a long history of recognition regarding foreign participants that are comparably regulated by a home country regulator. The CFTC enters into arrangements with our international counterparts for access to information and cooperative oversight. We have signed memoranda of understanding with regulators in Europe, North America and Asia.

Furthermore, Section 722(d) of the Dodd-Frank Act states that the provisions of the Act relating to swaps shall not apply to activities outside the U.S. unless those activities have “a direct and significant connection with activities in, or effect on, commerce” of the U.S. We are developing a plan for application of 722(d) and expect to receive public input on that plan.

I will highlight a few broad areas where both regulators in the U.S. and regulators abroad are implementing swaps oversight reform.

Broadening the Scope

Foremost, the Dodd-Frank Act broadened the scope of oversight. The CFTC and the SEC will, for the first time, have oversight of the swaps and security-based swaps markets. The

CFTC's remit is growing from a marketplace that has a notional value of approximately $40 trillion to one with a notional value of approximately $300 trillion.

Similar to the Dodd-Frank Act, the European Commission's proposal covers the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps. It is important that all standardized swaps are subject to mandatory central clearing. We are working with our counterparts in Europe to make sure that all swaps, whether bilateral or traded on platforms, are subject to such mandatory clearing.

Centralized Clearing

Another key reform of the Dodd-Frank Act is to lower interconnectedness in the swaps markets by requiring standardized swaps between financial institutions to be brought to central clearing. This interconnectedness was, in part, the reason for the $180 billion bailout of AIG.

Clearing is another area where the Dodd-Frank Act and the E.C.'s proposal generally are consistent. In both cases, financial entities, such as swap dealers, hedge funds and insurance companies, will be required to use clearinghouses when entering into standardized swap transactions with other financial entities. Non-financial end-users that are using swaps to hedge or mitigate commercial risk, however, will be able to choose whether or not to bring their swaps to clearinghouses.

Capital and Margin

The Dodd-Frank Act includes both capital and margin requirements for swap dealers to lower risk to the economy. Capital requirements, usually computed quarterly, help protect the public by lowering the risk of a dealer's failure. Margin requirements, usually paid daily, help protect dealers and their counterparties in volatile markets or if either of them defaults. Both are important tools to lower risk in the swaps markets.

The Dodd-Frank Act authorizes bank regulators, the CFTC and the SEC to set both capital and margin "to offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared."

In Europe, Basel III includes capital requirements for swap dealers. The E.C.'s swaps proposal includes margin requirements for uncleared swaps to lower the risk that a dealer's failure could cascade through its counterparties.

Data Reporting

The Dodd-Frank Act includes robust recordkeeping and reporting requirements for all swaps transactions. It is important that all swaps – both on-exchange and off – be reported to data repositories so that regulators can have a window into the risks posed in the system and can police the markets for fraud, manipulation and other abuses.

There is broad international consensus on the need for data reporting on swaps transactions. The E.C. proposal includes similar requirements to the Dodd-Frank Act's requirements. Regulators in Japan, Hong Kong and China also have indicated the need for reporting of swaps data.

Business Conduct Standards

The Dodd-Frank Act explicitly authorizes regulators to write business conduct standards to lower risk and promote market integrity. The E.C. proposal addresses similar protections through what it calls "risk mitigation techniques." This includes documentation, confirmation and portfolio reconciliation requirements, which are important features to lower risk. Further, the Dodd-Frank Act provides regulators with authority to write business conduct rules to protect against fraud, manipulation and other abuses.

Promoting Transparency

In the U.S., the Dodd-Frank Act brings transparency to the derivatives marketplace. Economists and policymakers for decades have recognized that market transparency benefits the public.

The more transparent a marketplace is, the more liquid it is, the more competitive it is and the lower the costs for hedgers, borrowers and their customers.

The Dodd-Frank Act brings transparency in each of the three phases of a transaction.

First, it brings pre-trade transparency by requiring standardized swaps – those that are cleared, made available for trading and not blocks – to be traded on exchanges or swap execution facilities.

Second, it brings real-time post-trade transparency to the swaps markets. This provides all market participants with important pricing information as they consider their investments and whether to lower their risk through similar transactions.

Third, it brings transparency to swaps over the lifetime of the contracts. If the contract is cleared, the clearinghouse will be required to publicly disclose the pricing of the swap. If the contract is bilateral, swap dealers will be required to share mid-market pricing with their counterparties.

The Dodd-Frank Act also includes robust recordkeeping and reporting requirements for all swaps transactions so that regulators can have a window into the risks posed in the system and can police the markets for fraud, manipulation and other abuses.

In Europe, the E.C. is considering revisions to its existing Markets in Financial Instruments Directive (MiFID), which includes a trade execution requirement and the creation of a report with aggregate data on the markets similar to the CFTC's Commitments of Traders reports.

Furthermore, in February 2011, IOSCO issued a report on trading that included eight characteristics that trading platforms should have. Many of the IOSCO members participating in the report indicated a belief that added benefits are achieved through multi-dealer trading platforms. The IOSCO report concluded that, beyond the added benefits of pre-trade transparency, trading helps mitigate systemic risk and protect against market abuse.

Japan's swaps reform promotes transparency through mandated post-trade reporting to a trade repository. Hong Kong is examining exchange-trading and electronic platform requirements as it pursues derivatives reform. China intends to mandate electronic trading of RMB FX forwards, RMB forward swaps and RMB currency swaps on trading platforms by the end of 2012.

Foreign Boards of Trade

The Dodd-Frank Act broadened the CFTC's oversight to include authority to register foreign boards of trade (FBOTs) providing direct access to U.S. traders. To become registered, FBOTs must be subject to regulatory oversight that is comprehensive and comparable to U.S. oversight. This new authority enhances the Commission's ability to ensure that U.S. traders cannot avoid essential market protections by trading contracts on FBOTs that are linked with U.S. contracts.

Access to Data

The Dodd-Frank Act includes a provision that generally requires domestic and foreign authorities, in certain circumstances, to provide written agreements to indemnify SEC- and CFTC-registered trade repositories, as well as the SEC and CFTC, for certain litigation expenses as a condition to obtaining data directly from the trade repository regarding swaps and security-based swaps. In addition, the trade repository must notify the SEC or CFTC upon receipt of an information request from a domestic or foreign authority.

After having consulted with staff, SEC Chairman Shapiro and I wrote to European Commissioner Barnier to indicate our belief that the indemnification and notice requirements need not apply to requests for information from foreign regulators in at least two circumstances.

First, the indemnification and notice requirements need not apply when a trade repository is registered with the SEC or CFTC, is registered in a foreign jurisdiction and the foreign regulator, acting within the scope of its jurisdiction, seeks information directly from the trade repository. In such dual-registration cases, we acknowledged our belief that the Dodd-Frank Act's indemnification and notice requirements need not apply, provided that applicable statutory confidentiality provisions are met. Our staff is considering this, along with other recommendations, as it prepares final rules for the Commissions' consideration.

Second, as indicated in the SEC's and CFTC's proposed rules regarding trade repositories' duties and core principles, foreign regulators would not be subject to the indemnification and notice requirements if they obtain information that is in the possession of the SEC or CFTC. The

SEC and CFTC have statutory authority to share such information with domestic and foreign counterparts and have made extensive use of this authority in the past to share information with our counterparts around the world. Furthermore, separate statutory authority exists to allow the SEC and CFTC to obtain information from a trade repository on behalf of a foreign regulator if that foreign regulator is investigating a possible violation of foreign law.

I anticipate that the CFTC staff will make additional recommendations for the Commission's consideration to facilitate regulators' access to information necessary for regulatory, supervisory and enforcement purposes.

Rule-Writing Process

The CFTC is working deliberatively, efficiently and transparently to write rules to implement the Dodd-Frank Act. The Commission on Tuesday scheduled public meetings in July, August and September to begin considering final rules under Dodd-Frank. We envision having more meetings throughout the fall to take up final rules.

The Dodd-Frank Act has a deadline of 360 days after enactment for completion of the bulk of our rulemakings – July 16, 2011. The Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. We are coordinating closely with the SEC on these issues.

The Dodd-Frank Act made many significant changes to the CEA. Section 754 of the Dodd-Frank Act states that Subtitle A of Title VII – the Subtitle that provides for the regulation of swaps – "shall take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provisions of this subtitle."

Thus, those provisions that require rulemakings will not go into effect until the CFTC finalizes the respective rules. Furthermore, they will only go into effect based on the phased implementation dates included in the final rules. During Tuesday's public Commission meeting, the CFTC released a list of the provisions of the swaps subtitle that require rulemakings.

Unless otherwise provided, those provisions of Title VII that do not require rulemaking will take effect on July 16. The Commission on Tuesday voted to issue a proposed order that would provide relief until December 31, 2011, or when the definitional rulemakings become effective, whichever is sooner, from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This includes provisions that do not directly rely on a rule to be promulgated, but do refer to terms that must be further defined by the CFTC and SEC, such as "swap" and "swap dealer."

The order proposed by the Commission also would provide relief through no later than December 31, 2011, from certain CEA requirements that may result from the repeal, effective on July 16, 2011, of some of sections 2(d), 2(e), 2(g), 2(h) and 5d.

The proposed order will be open for public comment for 14 days after it is published in the Federal Register. We intend to finalize an order regarding relief from the relevant Dodd-Frank provisions before July 16, 2011.

Conclusion

Though two years have passed, we cannot forget that the 2008 financial crisis was very real. Effective reform cannot be accomplished by one nation alone. It will require a comprehensive, international response. With the significant majority of the worldwide swaps market located in the U.S. and Europe, the effectiveness of reform depends on our ability to cooperate and find general consensus on this much needed regulation.

Thank you, and I’d be happy to take questions.