STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

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Good afternoon Chairman Bingaman, Ranking Member Murkowski and members of the Committee. Thank you for inviting me to testify regarding the regulation of over-the-counter (OTC) derivatives, particularly with respect to energy markets. I am pleased to testify on behalf of the Commodity Futures Trading Commission.

The 2008 financial crisis left us with many lessons and many challenges to tackle. Though there were certainly many causes of the crisis, I think most would agree that the unregulated OTC derivatives marketplace played a central role. We must now bring comprehensive regulatory reform to the OTC marketplace for derivatives.

CFTC Regulatory Regime

Before I discuss the details of much-needed OTC derivatives reform, let me take a moment to discuss the Commodity Futures Trading Commission's (CFTC) current oversight of particular derivatives markets, called futures markets. Futures have traded since the Civil War, when grain merchants came together to hedge the risk of changes in the price of corn, wheat and other grains on a central exchange. It took nearly 60 years until Congress first brought Federal regulation to the futures markets. President Roosevelt and Congress further responded to our last great financial crisis by strengthening regulation and oversight of the commodities and futures markets through the Commodity Exchange Act (CEA), which created the CFTC's predecessor within the Agriculture Department.

The CFTC ensures that futures and commodity options exchanges protect market participants and promote fair and orderly trading, free from fraud, manipulation and other abuses. Exchanges are where buyers and sellers meet and enter into transactions. The CFTC also oversees clearinghouses, which enter the picture only after two counterparties complete a transaction. Clearinghouses act as middlemen between and guarantee the obligations of the two parties to the trade and take on the risk that one party may fail to meet its obligations for the duration of the contract. Centralized clearing has helped lower risk to the markets for more than a century, in both calm markets and in the stormiest of markets, such as during the 2008 financial crisis.

In addition to regulating exchanges and clearinghouses, the CFTC regulates market participants, including futures commission merchants, commodity trading advisors and commodity pool operators. The CFTC has wide-ranging transparency efforts designed to provide the public much information about commodity futures markets and trading. The agency also has broad surveillance and enforcement powers to police the markets for fraud, manipulation and other abuses.

CFTC Coordination with Other Agencies

While many different federal agencies oversee various cash markets throughout the economy, Congress determined that the CFTC should be the sole agency to oversee trading on futures exchanges. One of the principal reasons that Congress mandated this exclusive jurisdiction was to bring uniformity to the regulation of the regulated derivatives markets. Importantly, the CFTC also was given the authority to provide exemptions from regulatory requirements for specific instruments or markets where it is in the public interest to do so.

Though the CFTC has exclusive jurisdiction over the futures markets, it coexists and routinely cooperates with other agencies that have jurisdiction over cash markets for the underlying commodities. The Department of Agriculture, for example, regulates marketing standards for corn and cash milk prices, while the CFTC regulates corn and milk futures. The Grain Inspection, Packers and Stockyards Administration oversees spot livestock markets, while the CFTC regulates livestock futures. The Treasury Department oversees the issuance of all Treasury Bills, Notes and Bonds, while the CFTC oversees futures contracts based on those instruments. The Federal Reserve Board oversees interest rate levels, while the CFTC oversees interest rate futures. The Federal Energy Regulatory Commission (FERC) oversees important aspects of the energy markets, including monitoring natural gas pipelines and regulating for just and reasonable wholesale electricity rates and interstate transmission service of electricity, while the CFTC oversees futures markets and certain electronic trading facilities for natural gas and electricity derivatives.

Regulation of Energy Futures Markets

A transparent and consistent playing field for all physical commodity futures – from agricultural products, such as corn and wheat, to energy products, such as crude oil and natural gas – should be the foundation of our regulations. In the energy markets, the CFTC currently oversees the trading of futures and options on futures on crude oil, heating oil, natural gas, gasoline and electricity, among others, traded on designated contract markets, such as the New York Mercantile Exchange (NYMEX), and on an exempt commercial market – the Intercontinental Exchange (ICE).

Vibrant energy futures markets are vital to the American economy. In 2009, more than 377 million energy futures and options contracts were traded on CFTC-regulated exchanges. The highest volume crude oil futures market was NYMEX's West Texas Intermediate crude oil contract with 137 million contracts. That is the equivalent of 137 billion barrels of oil –equal to the United States usage for about 11 years – with a notional value of nearly $9 trillion. The largest contract in natural gas was NYMEX's Henry Hub contract with 48 million contracts. That is the equivalent of 480 billion mmBTU's of natural gas with a notional value of $2.17 trillion. Energy futures and options markets also include very significant trading in electricity contracts, which, as a class, had more than 26.4 million contracts traded representing 7% of the overall futures and options trading volume in the energy sector.

Congress has continued to reaffirm the CFTC’s role in regulating futures markets. In the 2008 Farm Bill, Congress broadened the CFTC’s authority to regulate derivatives, including energy derivatives, traded on previously-exempted electronic trading facilities, called exempt commercial markets (ECMs). If a contract that is traded on one of these facilities is found to perform a significant price discovery (SPDC) function, the trading of that contract on that facility is subject to heightened regulation and required to comply with key core principles that also apply to the trading of futures contracts.

The Commission has so far determined that the ICE Henry Financial LD1 Fixed Price Contract traded on the ICE – the largest volume natural gas swap contract traded on an ECM – serves a significant price discovery function, and thus subject to heightened regulation. Following the statutory obligations of the 2008 Farm Bill, the CFTC is analyzing - and has sought public comment on - an additional 42 energy contracts, including natural gas and electricity contracts, to determine whether they meet the criteria to be regulated as SPDCs.

OTC Derivatives Regulation

Nearly 60 years after the futures markets were regulated, the first OTC swap was transacted in 1981. During its early years, the OTC marketplace was highly tailored to meet specific risk management needs. Contracts were negotiated between dealers and their corporate customers seeking to hedge specific financial risks. In contrast to the regulated futures markets, these early OTC derivatives were not traded on exchanges. Instead, OTC derivatives were transacted bilaterally, with dealers standing between their various customers. In this market structure, dealers keep transactions on their books, leaving the financial institutions more interconnected with all of their customers and limiting the amount of relevant pricing information available to the public.

In the last three decades, the over-the-counter derivatives marketplace has grown up, but it remains largely unregulated. Since the 1980s, the notional value of the market has ballooned from less than $1 trillion to approximately $300 trillion in the United States – that's $20 in derivatives for every dollar of goods and services produced in the American economy. The contracts have become much more standardized, and rapid advances in technology – particularly in the last ten years – now can facilitate transparent trading of much of this market on electronic platforms. While so much of this marketplace has changed significantly, the constant that remains is that it is largely unregulated and still dealer dominated.

It is now time to bring comprehensive regulation to this large and economically significant market. In well functioning markets, derivatives are meant to mitigate and help manage risk in the economy. Even if not for the 2008 financial crisis, this market should be regulated to achieve these goals. The financial crisis only highlights this in dramatically revealing how unregulated OTC derivatives and their dealers actually can heighten and concentrate risk to the great detriment of the American public. The need for broad based reform is the ultimate lesson of AIG and the broader risks brought about by the unregulated OTC derivatives market.

Effective reform requires many pieces. I will focus on the three essential components that should be enacted to promote transparency and reduce risk to the American public.

First, we must establish an explicit regulatory framework for swap dealers and major swap participants.

Second, we must bring transparency to these markets by requiring that standardized derivatives be traded on regulated trading platforms.

Third, we must lower the risk to the American public of financial institutions that have become both "too big to fail" and "too interconnected to fail" by requiring that their standardized derivatives be brought to central clearinghouses.

Regulating the Dealers

There is now broad consensus that dealers should be regulated for all of their derivatives business, both customized transactions and standardized ones. Swap dealers and major swap participants should maintain sufficient capital and meet margin requirements on their swap businesses to lower risk to the American public. They should be required to meet business conduct standards to a) promote market integrity by protecting against fraud, manipulation and other abuses and to b) lower risk through uniform back office standards for netting, processing and documentation. This should include authority for regulators to set aggregate position limits for OTC derivatives contracts when they perform or affect a significant price discovery function with respect to regulated markets. Swap dealers and major swap participants also should meet recordkeeping and reporting requirements promoting transparency to the regulators.

Transparent Trading Requirement

It is not enough, though, simply to promote transparency to the regulators. Financial reform will be incomplete if we do not make the OTC derivatives marketplace transparent to the public.

The majority of the OTC market, by some estimates more than three quarters of the market, could be cleared by a clearinghouse. Customized contracts - those that are so tailored that they cannot be cleared by a clearinghouse or listed on a trading platform - should be allowed to be transacted bilaterally, with the dealers subject to comprehensive regulation for these transactions.

This leaves the important public policy question of whether to require standardized OTC transactions to be brought to transparent, regulated, trading platforms. An opaque derivatives market, concentrated amongst a small number of financial institutions, though, contributed to bringing our financial system to the brink of collapse. Public market transparency greatly improves the functioning of existing securities and futures markets. We should shine the same light on the OTC derivatives markets.

The more transparent a marketplace, the more liquid it is. The more transparent a marketplace, the more competitive it is. And the more transparent a marketplace, the lower the costs for hedgers, borrowers and, ultimately, their customers. The best way to bring transparency is through regulated trading facilities and exchanges - including establishing a mechanism to provide for the timely public reporting of key trading data. Such centralized trading venues not only bring greater transparency, but increase competition in the markets by encouraging market-making and the provision of liquidity by a greater number of participants. A greater number of market makers brings better pricing and lowers risk to the system.

Further, clearinghouses would be far more able to assess and mange the risk of OTC derivatives with the benefit of transparent trading markets. A critical element of managing clearinghouse risk is marking all cleared positions to a reliable and transparent market price.

Absent the transparency provided by trading venues, clearinghouses have less reliable prices when marking to market the derivatives they clear and, thus, are less able to manage their risk and protect the public.

Some on Wall Street have suggested that they could support a clearing requirement, but see no need for a transparency requirement. But make no mistake: transparency is an absolutely essential component of reform. Congress should require that all standardized OTC derivative transactions be moved onto regulated transparent exchanges or trade execution facilities.

Mandating Clearing of Standardized Derivatives

Congress also should require derivatives dealers to bring their completed standardized derivatives transactions to regulated clearinghouses.

Currently, OTC derivatives transactions stay on the books of the dealers, often for many years after they are arranged. These dealers engage in many other businesses, such as lending, underwriting, asset management, securities trading and deposit-taking. When there is a better alternative through central clearing, why leave these derivatives transactions on the books of the swap dealers when these institutions are possibly “too big to fail?” Bilateral derivatives also leave a financial institution possibly “too interconnected to fail.” Leaving standardized OTC derivatives transactions on the books of the banks further aggravates the Governments’ dilemma when faced with a failing institution. Central clearing would greatly reduce both the size of dealers as well as the interconnectedness between Wall Street banks, their customers and the economy.

Some corporations have expressed concerns regarding posting the collateral required to clear a contract. While this is a legitimate public policy debate, I believe that the public is best served by lowering risk to the system as a whole. An exemption from clearing for this large class of transactions would allow dealers to keep significant risk on their books – risk that could reverberate throughout the entire financial system if a bank fails. Further, it is not clear that posting collateral necessarily increases costs to end users, since dealers charge corporations for credit extensions when the corporations do not post margin.

If Congress ultimately determines that commercial end-users' transactions should be exempt from a clearing requirement, the exemptions should be narrow. Data from the Bank for International Settlements shows that dealer-to-dealer transactions comprise 40 percent or less of the market in most contracts. Contracts with financial firms make up the bulk of transactions with non-dealers. For instance, swaps with non-dealer financial firms make up 57 percent of the interest rate derivatives markets. Exempting transactions with non-dealer financial firms exposes the American public to great risk by leaving the broader financial system significantly interconnected through their standard derivatives transactions. At a minimum, legislation should mandate that trades between dealers and other financial firms be cleared on regulated clearinghouses. Hedge funds, for example, should not be exempt from a clearing requirement with respect to their OTC transactions.

Further, any commercial end-user exception from clearing should not bring along an exemption from a transparency requirement. Commercial end-users have raised concerns about posting margin if they are required to clear their transactions. Separating the trading requirement from the clearing requirement can address this concern, if need be. Indeed, most commercial end-users would benefit from greater transparency than Wall Street currently provides.

Regulation of Electricity Derivatives

As we move to bring comprehensive reform to the OTC derivatives marketplace, the new authorities granted to market regulators will necessarily relate to existing authorities of other federal regulators. Specifically, CFTC authorities for OTC energy derivatives would relate to the FERC's authority under the Natural Gas Act and the Federal Power Act, including the authority to regulate certain activities of Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs). Consistent with the CFTC's and FERC's currently co-existing regulatory authorities, both agencies should continue to apply their authorities to the activities that are within their respective jurisdictions.

The CFTC has exclusive jurisdiction over the trading and clearing of futures contracts, whereas the FERC has jurisdiction over other defined aspects of the energy markets, including regulating interstate transportation rates and services for natural gas pipelines and regulating wholesale sales of electricity and interstate transmission rates and services. The FERC also has important enforcement authorities under the Federal Power Act and the Natural Gas Act to prosecute manipulation in the electricity and natural gas markets. Contracts for the immediate or forward delivery of electricity – like all cash and forward contracts for other commodities – are not regulated by the CFTC.

Congress has provided the agencies with adequate tools to work cooperatively. The CEA provides the CFTC with authority to exempt instruments and markets from its regulations if it is determined to be in the public interest to do so. OTC derivatives reform should extend this exemptive authority with the CFTC's oversight of the swaps market. Any potential overlaps in oversight can be addressed through memoranda of understanding and other cooperative working relationships between the two agencies. Pending legislation also should maintain the FERC's enforcement authorities under Section 222 of the Federal Power Act and Section 4A of the Natural Gas Act.

In contrast, wholesale statutory exemptions preventing the application of any CFTC regulation – including the regulation of futures contracts, swaps contracts, clearing or exchange trading – for any instrument or market that is regulated by the FERC undermine the effectiveness of comprehensive reform. Congress should avoid any bright-line exemption that runs the risk of creating the next regulatory loophole. Instead, Congress should follow the long established model under which the CFTC coexists with other agencies with oversight of cash and forward markets.

History demonstrates that bright-line statutory exemptions or exclusions granted at one point in time can have unintended consequences and often fail to adequately account for subsequent developments. Markets evolve rapidly. What may seem like a carefully crafted exclusion today can become a significant and problem-filled loophole tomorrow. When the Enron loophole was included in statute in 2000, electronic trading facilities were in their infancy. By the time Congress addressed the loophole as part of the Farm Bill in 2008, the unregulated electronic trading of natural gas swaps was on a par with the trading of natural gas futures on the regulated market. As the Amaranth case demonstrated, traders took advantage of the unregulated exempt facility to avoid position limits and other regulations established for the regulated futures markets. Proponents of the exemptions had argued that additional CFTC regulation was unnecessary. Our experience, though, indicates that comprehensive and consistent oversight must be applied.

Closing

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.