TESTIMONY OF GARY GENSLER
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
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Good morning Chairman Johnson, Ranking Member Shelby and members of the Committee. I thank you for inviting me to today's hearing on monitoring systemic risk and promoting financial stability. I am pleased to testify alongside my fellow regulators.

This morning I will provide an update on the status of the Commodity Futures Trading Commission's (CFTC's) process to implement the derivatives titles of the Dodd-Frank Wall Street Reform and Consumer Protection Act and discuss the how the CFTC has contributed to the Financial Stability Oversight Council (FSOC). Before I begin, I'd like to thank my fellow Commissioners the hardworking staff of the CFTC for their continued efforts to implement the Dodd-Frank Act.

Dodd-Frank Implementation Status

The CFTC is working deliberatively, efficiently and transparently to implement the Dodd-Frank Act. At this point, we have substantially completed the proposal phase of our rule-writing to implement the Dodd-Frank Act. Since the President signed the Dodd-Frank Act last July, the Commission has promulgated rules covering all of the areas set out by the Act for swaps regulation, with the exception of the Volcker Rule, for which the Act set a different timeline.

With the substantial completion of the proposal phase of rule-writing, the public now has the opportunity to review the whole mosaic of rules. This will allow market participants to evaluate the entire regulatory scheme as a whole.

To further facilitate this process, last month the Commission approved reopening or extending the comment periods for most of our Dodd-Frank proposed rules for an additional 30 days.

This time will allow the public to submit any comments they might have after seeing the entire mosaic at once. As part of this, I am hopeful that market participants will continue to comment about potential compliance costs as well as phasing of implementation dates to help the agency as we go forward with finalizing rules.

We will begin considering final rules only after staff can analyze, summarize and consider comments, after the Commissioners are able to discuss the comments and provide feedback to staff, and after the Commission consults with fellow regulators on the rules.

One component that we have asked the public about is phasing of rule implementation. Earlier this month, CFTC staff worked with SEC staff to host a roundtable to hear directly from the public about the timing of implementation dates of Dodd-Frank rulemakings. Prior to the roundtable, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective dates of final rules for swaps under the Dodd-Frank Act. We also opened a public comment file last month to hear specifically on this issue. The roundtable and public comments help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time.

Though we have substantially completed the proposal phase of rule-writing, the public will not be adequately protected until the agency completes final rules.

Rules Relating to Systemic Risk

The CFTC has proposed rules in three primary areas that are intended, in part, to lower systemic risk: regulating swap dealers, promoting transparency in the swap markets and requiring clearing of standardized swaps.

Regulating Swap Dealers

The financial crisis demonstrated the risk to the public of ineffectively regulated swap dealers. The Dodd-Frank Act addresses this by requiring comprehensive oversight of swap dealers. The CFTC has proposed rules to fulfill the Dodd-Frank Act's mandate that dealers meet minimum capital requirements to prevent a dealer's failure. We also have proposed rules mandated by the Dodd-Frank Act to require margin – or collateral – requirements to help prevent one financial entity's failure from spreading through the financial system to other entities and the broader economy. Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. Consistent with this, the CFTC's proposed margin rules focus only on transactions between financial entities rather than those transactions that involve non-financial end-users. Further, we have proposed business conduct standards, including documentation, confirmation and portfolio reconciliation requirements. Each of these is an important tool to lower risk that the swap markets pose to the economy.

We also have proposed rules under the Dodd-Frank Act that set business conduct rules and set position limits to promote market integrity and protect against fraud, manipulation and other abuses. This helps ensure that the users of derivatives get the benefit of transparent, open and competitive markets.

Promoting Transparency

The Dodd-Frank Act includes essential reforms to bring sunshine to the opaque swaps markets. Economists and policymakers for decades have recognized that market transparency benefits the public. Transparency also helps lower systemic risk. The more transparent a marketplace is, the more liquid it is for standardized instruments, the more competitive it is and the lower the costs for hedgers, borrowers and, ultimately, their customers.

The CFTC has proposed rules to implement the Dodd-Frank Act's mandate to bring transparency to the swaps market in each of the three phases of a transaction. First, we have proposed rules to bring transparency to the time immediately before the transactions are completed, so-called pre-trade transparency. This will be required for those standardized swaps

– those that are cleared, made available for trading and not blocks – that the Dodd-Frank Act mandates be traded on exchanges or swap execution facilities (SEFs).

Exchanges and SEFs will allow investors, hedgers and speculators to meet in a transparent, open and competitive central market. This will benefit end-users by providing better pricing on derivatives transactions.

Second, as required by the Dodd-Frank Act, the CFTC has written rules to bring real-time transparency to the pricing immediately after a swap transaction takes place. This post-trade transparency provides all end-users and market participants with important pricing information as they consider whether to lower their risk through a similar transaction.

Third, the CFTC has proposed rules as mandated by the Dodd-Frank Act to bring transparency to swaps over the lifetime of the contracts. End-users and the public will benefit from knowing the valuations of outstanding swaps on a daily basis. If the contract is cleared, proposed rules would require the clearinghouse to publicly disclose the daily settlement price for each swap cleared by the clearinghouse. If the contract is bilateral, proposed rules would require swap dealers to share mid-market pricing with their counterparties every day and agree on valuation methodologies in their swap documentation. This daily valuation will help prevent similar scenarios to 2008 when we were unable to price "toxic assets."

Additionally, we have proposed rules to make the swaps markets transparent to regulators through swap data repositories. The Dodd-Frank Act Act 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.

Lowering Risk through Central Clearing

The Dodd-Frank Act also requires that standardized swap transactions between financial entities be brought to clearinghouses. Central clearing has been a feature of the U.S. futures markets since the late-19th century. Clearinghouses act as middlemen between two parties to a derivatives transaction after the trade is arranged. They protect the financial system and the broader economy from the failure of a swap dealer. They require dealers to post collateral so that if one party fails, its failure does not harm its counterparties and reverberate throughout the financial system. They have functioned both in clear skies and during stormy times – through the Great Depression, numerous bank failures, two world wars and the 2008 financial crisis – to lower risk to the economy.

Currently, swap transactions stay on the books of the dealers that arrange them, often for many years after they are executed. Like AIG did, these dealers engage in many other businesses, such as lending, underwriting, asset management, securities trading and deposit-taking. These dealers often are interconnected with other financial entities. This interconnectedness heightens the risk that a dealer's failure will reverberate throughout the economy as a whole. Uncleared swaps allow the failure of one institution to potentially cascade, like dominoes, throughout the financial system and ultimately crash down on the public.

The CFTC has proposed rules to implement the Dodd-Frank Act's clearing mandate and its requirement for enhanced oversight of clearinghouses. In close consultation with our fellow domestic and international regulators, and particularly with the Federal Reserve and the Securities and Exchange Commission (SEC), the CFTC proposed rulemakings on risk management for clearinghouses. These rulemakings take account of relevant international standards, particularly those developed by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions.

The Financial Stability Oversight Council

The Dodd-Frank Act established the FSOC to ensure protections for the American public. The Council is an opportunity for regulators – now and in the future – to ensure that the financial system works better for all Americans. The financial system should be a place where investors and savers can get a return on their money. It should provide transparent and efficient markets where borrowers and people with good ideas and business plans can raise needed capital.

The financial system also should allow people who want to hedge their risk to do so without concentrating risk in the hands of only a few financial firms. One of the challenges for the Council and for the American public is that the financial industry has gotten very concentrated around a small number of very large firms. As it is unlikely that we could ever ensure that no financial institution will fail – because surely, some will in the future – we must do our utmost to ensure that when those challenges arise, the taxpayers are not forced to stand behind those institutions and that these institutions are free to fail.

There are important decisions that the Council will make, such as determinations about systemically important nonbank financial companies and systemically important financial market utilities, such as clearinghouses, resolving disputes between agencies and completing important studies as dictated by the Dodd-Frank Act. Though these specific decisions are important, to me it is essential that the Council make sure that the American public doesn't bear the risk of the financial system and that the system works for the American public, for investors, for small businesses, for retirees and for homeowners.

The Council's eight current voting members have coordinated closely. Treasury's leadership has been invaluable. To support the FSOC, the CFTC is providing both data and expertise relating to a variety of systemic risks, how those risks can spread through the financial system and the economy and potential ways to mitigate those risks. We also have had the opportunity to coordinate with Treasury and the Council on each of the studies and proposed rules issued by the FSOC.

I will focus this portion of my testimony discussing a number of matters that have been on the FSOC's agenda.

Clearinghouses

Title VIII of the Dodd-Frank Act gives the FSOC important roles in clearinghouse oversight by authorizing the Council to designate certain clearinghouses as systemically important. Title VIII also permits the Federal Reserve to join in the examination of such clearinghouses and to recommend heightened prudential standards in certain circumstances.

The FSOC's notice of proposed rulemaking on designating systemically important financial market utilities complements the CFTC's rulemaking efforts that I described above. Public input will be valuable in determining how the Council should apply statutory criteria to determine which clearinghouses qualify for designation as systemically important.

Volcker Rule Study

Section 619 of the Dodd-Frank Act provides that, other than certain permitted activities, "a banking entity shall not engage in proprietary trading, including trading in futures, options on futures and swaps." The CFTC is directed to adopt rules to carry out this requirement with respect to any entity "for which the CFTC is the primary financial regulatory agency."

As part of the Volcker rule's coordinated rulemaking requirement, CFTC staff has been meeting frequently with other agencies, including the Federal Deposit Insurance Corporation (FDIC), Federal Reserve, Office of the Comptroller of the Currency (OCC), SEC and Treasury Department. The goal of these meetings is to ensure, to the extent possible, that our rules on section 619 are comparable and provide for consistent application.

The FSOC's Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds, also known as the Volcker

Rule study, provides thoughtful recommendations to carry out Congress's intent to separate proprietary trading from otherwise permitted activities of banking entities. The study also provides a basis upon which each of our agencies can move forward with the required rule-writing to carry out Congress's mandate.

In particular, the study covers financial instruments both in the cash market and in the derivatives and swaps markets. This is significant, as any risk that a banking entity could take on in the cash markets also could be expressed through swaps and derivatives. The inclusion of both prevents regulatory arbitrage. In addition, the study indicates that the books of banking entities, including swap dealers, would not be precluded from the definition of a trading account regardless of whether those accounts held illiquid financial instruments, such as swaps, and regardless of whether those positions are short-term or long-term.

Supervision of Certain Nonbank Financial Companies and Concentration Limits

Title I of the Dodd-Frank Act authorizes the FSOC to determine whether certain activities of nonbank financial companies could pose a threat to the financial stability of the United States. Those companies would be supervised by the Federal Reserve and subject to specific prudential standards. In January, the FSOC issued a proposed rulemaking concerning its Authority to Require Supervision of Certain Nonbank Financial Companies. Effective regulation of systemically important nonbank financial entities is essential to preventing the next AIG from threatening the financial system.

The Dodd-Frank Act also includes a provision that no financial company be permitted to grow through either merger or acquisition if the resulting companies' consolidated liabilities would exceed 10 percent of all the aggregate consolidated liabilities of all financial companies. The FSOC's Study & Recommendations Regarding Concentration Limits on Large Financial Companies is an important step in implementing Congress's direction. These limits are designed to promote financial stability by preventing the liabilities of the financial sector from becoming too concentrated in any given financial entity. The 2008 financial crisis demonstrated the potential repercussions to the American public of concentration within our financial sector.

Annual FSOC Report to Congress

Under section 112 of the Dodd-Frank Act, the FSOC is to report annually to Congress. Staff of the CFTC, including in our Chief Economist's office, Division of Market Oversight, and Division of Clearing and Intermediary Oversight, have been contributing to that effort. I believe this annual report can serve as an important means for the Council to communicate to Congress on the stability of the financial system and make recommendations to enhance the U.S. financial markets and protect the public.

Coordination with FSOC Member Agencies

The CFTC is consulting heavily with the member agencies of the FSOC to implement the Dodd-Frank Act. We are working very closely with the SEC, Federal Reserve, FDIC, OCC and other prudential regulators, which includes sharing many of our memos, term sheets and draft work product. We also are working closely with the Treasury Department and the new Office of Financial Research. CFTC staff has had more than 600 meetings with other regulators on implementation of the Act. This close coordination has benefited the rulemaking process and will strengthen the markets. The CFTC will consider final rules only after we have the opportunity to consult with our fellow regulators.

Conclusion

Thank you for the opportunity to testify. I'd be happy to take questions.