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BEFORE THE

U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

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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 the one-year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC). I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation.

Financial Crisis

One year ago, the President signed the Dodd-Frank Act into law. And on this anniversary, it is important to remember why the law's derivatives reforms are necessary.

The 2008 financial crisis occurred because the financial system failed the American public. The financial regulatory system failed as well. When AIG and Lehman Brothers faltered, we all paid the price. The effects of the crisis remain, and there continues to be significant uncertainty in the economy.

Though the crisis had many causes, it is clear that the derivatives or swaps market played a central role. Swaps added leverage to the financial system with more risk being backed 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 – developed to help manage and lower risk for end-users – also concentrated and heightened risk in the financial system and to the public.

FSOC

To help protect the American public, the Dodd-Frank Act included the establishment of the Financial Stability Oversight Council. This Council is an opportunity for regulators – now and in the future – to ensure that the financial system works better for all Americans. Adding to our challenge is the perverse outcome of the financial crisis, which may be that many people in the markets have come to believe that a handful of large financial firms will – if in trouble – have the backing of the taxpayers. 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.

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 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 selling and services – while finding others in a marketplace willing to bear the uncertain risks of changes in prices or rates.

With notional values of more than $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 – derivatives markets must work for the benefit of the American public. Members of the public keep their savings with banks and pension funds that use swaps to manage interest rate risks. The public buys gasoline and groceries from companies that rely upon futures and swaps to hedge swings in commodity prices.

That's why 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 all of the derivatives markets.

The Dodd-Frank Act

To address the real weaknesses in swaps market oversight exposed by the financial crisis, the CFTC is working to implement the Dodd-Frank Act's swaps oversight reforms.

Broadening the Scope

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

Promoting Transparency

Importantly, the Dodd-Frank Act brings transparency to the swaps 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, which ultimately leads to lower costs for borrowers and the public.

The Dodd-Frank Act brings transparency to 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 to the system and can police the markets for fraud, manipulation and other abuses.

On July 7, the Commission voted for a significant final rule establishing that clearinghouses and swaps dealers must report to the CFTC information about the swaps activities of large traders in the commodity swaps markets. For decades, the American public has benefited from the Commission's gathering of large trader data in the futures market, and now will benefit from this additional information to police the commodity swaps markets.

Lowering Risk

Other key reforms of the Dodd-Frank Act will lower the risk of the swaps marketplace to the overall economy by directly regulating dealers for their swaps activities and by moving standardized swaps into central clearing.

Oversight of swap dealers, including capital and margin requirements, business conduct standards and recordkeeping and reporting requirements will reduce the risk these dealers pose to the economy.

The Dodd-Frank Act's clearing requirement directly lowers interconnectedness in the swaps markets by requiring standardized swaps between financial institutions to be brought to central clearing.

This week, the Commission voted for a final rule establishing a process for the review by the Commission of swaps for mandatory clearing. The process provides an opportunity for public input before the Commission issues a determination that a swap is subject to mandatory clearing. The Commission will start with those swaps currently being cleared and submitted to us for review by a derivatives clearing organization.

Enforcement

Effective regulation requires an effective enforcement program. The Dodd-Frank Act enhances the Commission's enforcement authorities in the futures markets and expands them to the swaps markets. The Act also provides the Commission with important new anti-fraud and anti-manipulation authority.

This month, the Commission voted for a final rule giving the CFTC authority to police against fraud and fraud-based manipulative schemes, based upon similar authority that the Securities and Exchange Commission, Federal Energy Regulatory Commission and Federal Trade Commission have for securities and certain energy commodities. Under the new rule, the Commission’s anti-manipulation reach is extended to prohibit the reckless use of fraud-based manipulative schemes. It closes a significant gap as it will broaden the types of cases we can pursue and improve the chances of prevailing over wrongdoers.

Dodd-Frank expands the CFTC's arsenal of enforcement tools. We will use these tools to be a more effective cop on the beat, to promote market integrity and to protect market participants.

Position Limits

Another critical reform of the Dodd-Frank Act relates to position limits. Position limits have been in place since the Commodity Exchange Act passed in 1936 to curb or prevent excessive speculation that may burden interstate commerce.

In the Dodd-Frank Act, Congress mandated that the CFTC set aggregate position limits for certain physical commodity derivatives. The law broadened the CFTC's position limits authority to include aggregate position limits on certain swaps and certain linked contracts traded on foreign boards of trade, in addition to U.S. futures and options on futures. Congress also narrowed the exemptions for position limits by modifying the definition of a bona fide hedge transaction.

When the CFTC set position limits in the past, the purpose was to ensure that the markets were made up of a broad group of market participants with a diversity of views. Market integrity is enhanced when participation is broad and the market is not overly concentrated.

Rule-Writing Process

The CFTC is working deliberatively, efficiently and transparently to write rules to implement the Dodd-Frank Act.

This spring, we substantially completed the proposal phase of rule-writing and further benefited from an extra 30 days for public comment. Now, the staff and commissioners have turned toward final rules. We held two public commission meetings this month and approved eight final rules. In the coming months, we will hold additional public meetings to continue to consider finalizing rules.

The Dodd-Frank Act set a deadline of 360 days for the CFTC and SEC to complete the bulk of our rulemakings, which was July 16, 2011.

Last week, the Commission granted temporary relief from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This order provides time for the Commission to continue its progress in finalizing rules.

Phasing of Implementation

The Dodd-Frank Act gives the CFTC and SEC flexibility to set effective dates and a schedule for compliance with rules implementing Title VII of the Act. The order in which the Commission finalizes the rules does not determine the order of the rules' effective dates or applicable compliance dates. Phasing the effective dates of the Act's provisions will give market participants time to develop policies, procedures, systems and the infrastructure needed to comply with the new regulatory requirements.

In May, CFTC and SEC staff held 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 and compliance dates of final rules for swaps under the Dodd-Frank Act. We also offered a 60-day public comment file to hear specifically on this issue. The roundtable and resulting public comment letters will help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time. This public input has been very helpful to staff as we move forward in considering final rules.

We are planning to request additional public comment on a critical aspect of phasing implementation – requirements related to swap transactions that affect the broad array of market participants. Market participants that are not swap dealers or major swap participants may require more time for the new regulatory requirements that apply to their transactions. There may be different characteristics amongst market participants that would suggest phasing transaction compliance by type of market participant. In particular, such phasing compliance may relate to: the clearing mandate; the trading requirement; and compliance with documentation standards, confirmation and margining of swaps.

Our international counterparts also are working to implement needed reform. We are actively consulting and coordinating with international regulators to promote robust and consistent standards and to attempt to avoid conflicting requirements in swaps oversight. 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 will seek public input on that plan in the fall.

Conclusion

Only with reform can the public get the benefit of transparent, open and competitive swaps markets. Only with reform can we reduce risk in the swaps market – risk that contributed to the 2008 financial crisis. Only with reform can users of derivatives and the broader public be confident in the integrity of futures and swaps markets.

The CFTC is taking on a significantly expanded scope and mission. The Commission must be adequately resourced to effectively police the markets and protect the public.

Without sufficient funds, there will be fewer cops on the beat. The agency must be adequately resourced to assure our nation that new rules in the swaps market will be strictly enforced -- rules that promote transparency, lower risk and protect against another crisis.

Until the CFTC completes its rule-writing process and implements and enforces those new rules, the public remains unprotected.

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