



Commodity Futures Trading Commission

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Remarks

Remarks of Chairman Gary Gensler Before the Managed Funds Association, Chicago, Illinois

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Thank you for that introduction, Richard. I greatly appreciate the invitation to speak to the Managed Funds Association at this critical time in our nation's economy. The last time the two of us were together with a crowd of this size, I was testifying as an Undersecretary at the Department of the Treasury before your Committee in the U.S. House of Representatives. Once again, we're together discussing challenges facing our financial system and possible solutions.

As President Obama announced exactly one week ago, we must urgently enact broad regulatory reforms of our financial system. The President's proposal offers bold reforms seeking to prevent the financial breakdowns that led to our current crisis. It is sweeping in scope, cutting across the financial system to provide greater oversight, transparency and accountability.

Today I would like to focus on two key areas: regulation of over-the-counter derivatives and hedge funds.

Over-the-Counter Derivatives

We must establish a regulatory regime to cover the entire over-the-counter derivatives marketplace.

This will help the American public by: One - lowering systemic risk. Two – providing transparency and efficiency in markets. Three - ensuring market integrity by preventing fraud, manipulation, and other abuses. And four - protecting the retail public.

This new regime should govern 100% of OTC derivatives no matter who is trading them or what type of derivative is traded, standardized or customized. That includes interest rate swaps, currency swaps, commodity swaps, equity swaps, credit default swaps or those which cannot yet be foreseen.

I envision this will require two complementary regimes --- one for regulation of the dealers and one for regulation of the market functions. Together, with both of these, we will ensure that the entire derivatives marketplace is subject to comprehensive regulation.

The current financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system. The costs to the public from the failure of these firms has been staggering, \$180 Billion of American taxpayer financial support for AIG alone. The AIG subsidiary that dealt in derivatives – AIG Financial Products –was not subject to any effective federal regulation. Nor were the derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks. As such, all derivatives dealers need to be subject to robust federal regulation.

Regulation of the dealers should set capital standards and margin requirements to lower risk. We also must set business conduct standards. These standards would guard against fraud, manipulation, and other market abuses. Additionally, they would lower risk by setting important back office standards for timely and accurate confirmation, processing, netting, documentation, and valuation of all transactions. Lastly, we must also mandate recordkeeping and reporting to promote transparency and to allow the CFTC and SEC to vigorously enforce market integrity.

By fully regulating the institutions that trade or hold themselves out to the public as derivative dealers we ensure that all OTC products, both standardized and customized, are subject to robust oversight. Particular care should be given to ensure that no gaps exist between the regulation of standardized and customized products. Customized derivatives, though allowed, would be subject to capital, margin, business conduct and reporting standards. Customized derivatives, however, are by their nature less standard, less liquid and less transparent. Therefore, I believe that higher capital and margin requirements for customized products are justified.

Beyond regulating the dealers, I believe that we must mandate the use of central clearing and exchange venues for all standardized derivatives. Derivatives that can be moved into central clearing should be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems.

Requiring clearing will promote market integrity and lower risks. 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.

I also would like to highlight three essential features for OTC central clearinghouses:

- Governance arrangements should be transparent and incorporate a broad range of viewpoints from members and other market participants,
- Central counterparties should 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, and

- Finally, in order to promote clearing and achieve market efficiency through competition, OTC derivatives should be fungible and able to be transferred between one exchange or electronic trading system to another.

Market transparency and efficiency would be further improved by requiring the standardized part of the OTC markets onto fully regulated exchanges and fully regulated transparent electronic trading systems. Experience has shown that President Franklin Roosevelt's approach is correct. To function well, markets must be properly-regulated and transparent. They simply cannot police themselves nor remain in the dark.

Regulated exchanges and regulated transparent trading systems will bring much needed transparency to OTC markets. Market participants should be able 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.

Market regulators 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.

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.

To fully achieve these objectives, we must enact both of these complementary regimes. Regulating both the traders and the markets will ensure that we cover both the actors and the stages that may create significant risks.

Hedge Funds

The second topic that I would like to discuss is regulation of hedge funds. President Obama has called for advisers to hedge funds and other investment funds to register with the SEC under the Investment Advisers Act. Advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability.

The Commodity Exchange Act (CEA) currently provides that funds trading in the futures markets register as Commodity Pool Operators (CPO) and file annual financials with the CFTC. Over 1300 CPOs, including many of the largest hedge funds, are currently registered with and make annual filings to the CFTC. It will be important that the CFTC be able to maintain its enforcement authority over these entities as the SEC takes on important new responsibilities in this area.

This financial crisis also gave new meaning to the term "run on the bank". Upon hearing those words, most of us would conjure up the image of the citizens of Bedford Falls

standing outside George Bailey's Savings and Loan in the movie *It's a Wonderful Life*. Last year, we witnessed the modern version of this in a number of ways. A harsh lesson of the crisis occurred when a significant number of hedge funds sought to pull securities and funds from their prime brokers, contributing to uncertainty and the destabilization of the financial system.

You may be aware of proposals being discussed by the International Organization of Securities Commissions (IOSCO) regarding the relationship between hedge funds and their prime brokerages and banks, which will require new oversight and rules of the road. Here at home, we should seriously consider similar principles to best guard against runs on liquidity by hedge funds.

In an effort to harmonize financial market oversight, the President requested the CFTC and SEC to provide a report to Congress by September 30, 2009. We will identify existing differences in statutes and regulations with respect to similar types of financial instruments, explain if differences are still appropriate, and make recommendations for changes. In developing recommendations for harmonization we will seek broad input from the public, other regulators, and market users.

Before closing, I would like to mention Chairman Levin's report on wheat convergence released today by the Senate Permanent Subcommittee on Investigations. Chairman Levin's report is a significant contribution to discussions regarding the potential effects of index trading in the wheat market and other commodity futures markets. As the Commission continues our own analysis and appropriate regulatory responses, Chairman Levin's recommendations will be carefully considered.

I would like to thank you again for having me here today, and I am happy to take questions.