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Remarks

Remarks of Chairman Gary Gensler, Regulatory Update, Natural Gas Roundtable Luncheon

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Good afternoon. It is a pleasure to be with you today at one of the defining moments in our nation's financial history. I'd like to thank David Sweet for that kind introduction and the Natural Gas Roundtable for inviting me.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public.

Congress responded swiftly to the crisis and committed more than $700 billion of taxpayer money to rescuing the financial industry – without which the financial system never would have stabilized. The crisis was not isolated to Bear Stearns, Lehman Brothers or AIG. It threatened the savings and livelihoods of every American. Let us recall, the financial bailout was only a means of getting a sinking ship back to port. It is now our responsibility to fix the ship before it can set sail again. We must ensure that this type of failure never threatens our nation again.

I speak to you today as someone who spent half my adult life working on Wall Street. I worked with talented individuals from around the world who operated at the highest levels of professionalism. The industry plays a fundamental role in pricing and allocating capital and risk in our economy.

But being talented and working in such a critical industry doesn't mean that individuals can't make mistakes or that the system is flawless. The crisis eased only through strenuous effort and some considerable good fortune. Now we must ensure that the risks generated by the financial sector are never allowed to push us so close to the brink again. Some may accuse us of overreacting and overreaching. But the worst financial crisis in 80 years demands the most comprehensive regulatory reform in generations.

Though there are certainly many causes of the crisis, I think most would agree that the unregulated OTC derivatives marketplace played a central role. The time has come for comprehensive regulation.

In just the past two weeks, two important committees in the U.S. House of Representatives – the Financial Services Committee and the Agriculture Committee – both passed historic legislation that, for the first time, introduces comprehensive regulation to the OTC derivatives marketplace.

Both of the committees' bills include three important elements of regulatory reform: First, they require swap dealers and major swap participants to register and come under comprehensive regulation. This includes capital standards, margin requirements, business conduct standards and recordkeeping and reporting requirements. Second, the bills require that dealers and major swap participants bring their clearable swaps into central clearinghouses. Third, they require dealers and major swap participants to use transparent trading venues for their clearable swaps and provide the CFTC with authority to impose position limits in the OTC derivatives markets.

Swap dealers are those entities that make markets in derivative instruments. A major swap participant is generally someone other than a dealer who maintains a substantial net position in outstanding swaps other than swaps used for commercial hedging or whose positions create substantial exposure to its counterparties or the system. The proposed legislation requires both swap dealers and major swap participants to register and be subject to comprehensive regulations as these participants are the most relevant to the overall safety of the financial system.

One of the lessons learned from last year's crisis is that some financial institutions had gotten so interconnected that their failure would pose great risk to the economy at large. Today, trades mostly remain on the books of large complex financial institutions, which internalize the volatile risks of their positions. This means that any financial firm is connected with literally thousands of counterparties located in every sector of our economy and in every state in our nation. This left an untenable decision for the government last year. That is why it is so important to move those transactions off the balance sheets and books of those financial institutions.

That's where a clearinghouse comes in. A clearinghouse stands between two counterparties in an over-the-counter derivative transaction to take on the risk of default by one of the counterparties. All OTC transactions, where possible, should be required to be cleared by robustly regulated central counterparties. Many of the institutions that currently keep trades on their books simultaneously engage in many other businesses – lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other hand, are solely in the business of clearing trades and managing the associated risk. To reduce systemic risk, it is critical that we move all standard swaps off the books of large financial institutions and into well-regulated clearinghouses.

I believe that all clearable transactions should be required to be brought to a clearinghouse, regardless of what type of entity is on either side of the trade. This would remove the greatest amount of interconnectedness from the large financial institutions. While the bills recently passed by the House Financial Services and Agriculture Committees are important steps forward, I believe they can be improved if modified to bring more transactions into central clearing. The bills limit the clearing requirement to transactions between swap dealers or major swap participants. Broadening coverage could result in substantial, further reduction in financial system

risk. Additional improvements could result in the clearing of all clearable transactions where either party is a hedge fund or another financial firm. These entities are responsible for a substantial share of the OTC derivatives market and they are capable of meeting these requirements that have such tremendous promise for the responsible management of financial risk.

Some commercial counterparties have raised concerns about the potential costs of requiring clearing of their transactions. I understand that some of you here today might worry that new margin requirements would add cost to doing business.

To address those concerns, I believe that commercial end-users should be permitted to access clearing through a clearing member. End-users should be permitted to establish a client relationship with clearing members whereby the clearing member would clear the transaction in a client account on behalf of the end-user. This is very similar to what currently exists in the futures marketplaces. I believe it would be appropriate for clearing members, most of whom would be financial institutions, to have the ability to enter into individualized credit arrangements with commercial end-users to satisfy margin obligations. This could include posting noncash collateral or another type of credit arrangement worked out by the end-user and clearing member. As a member of a clearinghouse, the clearing member would be subject to robust oversight for financial risk. Thus, we would be able to achieve the goal of bringing all standardized swaps to clearinghouses while concurrently allowing end-users to enter into appropriate, individualized credit terms with a clearing member.

If Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow. I believe that it is most critical that transactions with financial firms, hedge funds and other investment funds benefit from a clearing requirement. To be clear, these are transactions with entities that are not major swap participants. Let us recall, one of the lessons of last year's crisis was that our government was limited in its options when the big financial firms were in trouble because they were interconnected with thousands of derivatives counterparties. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system. Thus, I look forward to working with Congress to build upon their strong efforts to move more transactions into robustly regulated clearinghouses.

To promote market transparency, all standardized OTC products should be moved onto regulated exchanges or trade execution facilities. This is the best way to reduce information deficits for participants in these markets. Transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the swaps markets. Increasing transparency for standardized derivatives should enable both large and small end-users to obtain better pricing on standard and customized products. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will benefit all end-users, whether trading with standardized or customized swaps.

I believe that we can separate the debate of a corporate end-user clearing exception from whether there should be an end-user exception from transparency requirements. Transactions between swap dealers and end-users, even if the end-users are exempt

from margin requirements, should still be traded on exchanges or swap execution facilities. This will best promote the price discovery function of the markets.

Derivatives market reform has significant implications for another topic of particular interest to many in this room – the proper oversight of emissions trading markets that would result from potential cap-and-trade legislation currently being debated in Congress. As Congress moves forward, I believe it should fully regulate the expanded carbon markets – including the futures market, the OTC market and the cash market – without exception. Ensuring transparency, protecting price discovery and addressing financial risk are every bit as critical for emissions markets as other derivatives markets.

While other regulators would be in charge of the "cap" part of "cap-and-trade," the CFTC has broad experience regulating the "trade" part of existing emissions markets. To get the most benefit from a cap-and-trade program, it is essential that the trading markets are fair and orderly and that the price discovery process instills confidence. The Commission already oversees trading and clearing of futures and options contracts in the emissions allowance markets. This includes sulfur dioxide and nitrogen oxide related to the acid rain program and carbon dioxide allowances related to the Regional Greenhouse Gas initiative, made up of ten states from Maine to Maryland that regulate carbon emissions. The Commission has abundant experience in the regulation of centralized marketplaces. Should Congress seek to regulate cash markets for emission instruments, the Commission is well-suited to carry out that function.

In most respects, emissions contract markets operate no differently than the other commodity markets the CFTC regulates. While each contract – such as sulfur dioxide, wheat, treasury bills or natural gas – presents its own unique challenges, the overall regulatory scheme is essentially the same. We must protect against the same hazards in the carbon markets that we currently guard against in other commodity futures markets: fraud, manipulation and other abuses.

Price volatility has been of particular concern to many involved in the development of cap and trade legislation. While the CFTC is not a price setting agency, we strive to ensure that markets are transparent, fair and orderly. There may be specific facets of carbon markets that require particular protections, and I look forward to working with Congress, market participants and the public to offer the Commission's expertise in considering those. It is important that companies are able to make long-term capital commitments and hedge their long-term price risk of carbon emissions allowances. That is why it is critical to get the regulatory oversight right of both the futures markets and the OTC markets that may develop out of a cap-and-trade program.

Before I close, I will briefly discuss the Commission's current look into whether we should set position limits in the physical commodity markets, and specifically, the energy markets. I believe that we should consider setting position limits to guard against excessive concentration in the energy futures markets. The financial crisis highlighted the risk to the market and to the American public brought about by large concentrated actors on the financial stage.

When the CFTC set position limits for certain agricultural commodities, the agency sought to ensure that the markets were made up of a broad group of market participants with a diversity of views. This is not the only place in our economic regulatory structure

where we guard against concentration in markets. Setting concentration position limits in the energy markets would not be new or revolutionary; in fact, working with the exchanges, such concentration limits were set as recently as 2001.

In 1936, the Congress said that the CFTC "shall" impose limits on trading and positions as necessary to eliminate, diminish, or prevent the undue burdens resulting from outsized futures positions. The CFTC is mandated by statute to set position limits to protect the American public. I look forward to hearing from participants from today's roundtable on this very important issue.

Thank you for inviting me to speak today. I look forward to questions from the roundtable participants. I kindly ask that the press save their questions for after the Q and A.