



Commodity Futures Trading Commission

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Remarks

Remarks of Chairman Gary Gensler, OTC Derivatives Reform, Exchequer Club of Washington

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Good afternoon. It is a pleasure to be with you today. I'd like to thank the Exchequer Club of Washington for inviting me to speak on the need for comprehensive reform of over-the-counter (OTC) derivative markets.

Last year's crisis marks a defining moment in our nation's history. The crisis was a call to action for the Administration, Congress and market regulators to ensure that we do all we can to prevent the financial system from so undermining the economy and the wellbeing of the American public.

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 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.

Just this morning, I testified before the Senate Agriculture Committee on the need for comprehensive regulatory reform of OTC derivatives markets. In the past few weeks, both the House Agriculture Committee and the House Financial Services Committee passed historic legislation to introduce regulation to these markets. The Senate Banking Committee is working on similar reform.

The challenge remains, though, determining how far reform should reach. To comprehensively regulate derivatives, both the dealers and market functions must be covered. The Administration proposed, and there is now a broad consensus, to regulate the dealers for all of their derivatives business, both customized and standardized. Dealers would be regulated explicitly for capital, margin, business conduct, recordkeeping and reporting. This afternoon, I will focus on the complementary regulatory regime for the markets where derivatives trade.

OTC derivative transactions currently occur out of sight of federal regulators and out of sight of market participants. In aggregate, though, the notional amount of these transactions represents 15-20 times the size of our economy. I believe that regulatory reform must bring sunshine to as many derivatives transactions as possible by moving them into regulated, transparent trading venues.

Economists have for decades recognized that market transparency benefits the public. It also enables regulators to police the markets for fraud, manipulation and other abuses. As such, all standardized OTC derivative transactions should be moved onto regulated transparent exchanges or trade execution facilities. This would enable both large and small end-users to obtain better pricing on their derivative products. A municipality, for example, could better decide whether or not to hedge an interest rate risk based upon the reported pricing from exchanges.

Standard transactions involving end-users, such as corporations or hedge funds, should not be exempt from the transparency afforded by regulated exchanges and trade execution facilities. I do not see public policy reasons to exempt standard derivative transactions from a transparency requirement. In fact, I believe that corporate treasurers and assistant treasurers across America would find access to trading screens would greatly benefit their ability to determine the best price and hedge their risk. I am hopeful that we can build upon legislative efforts by bringing additional transparency to the opaque derivatives markets.

Though it is a significant step forward to require transactions amongst swap dealers and major swap participants (the interbank market) to be brought to trading venues, I believe this may leave out a significant part of the market, both in dollar amount and likely in greater portion measured in number of transactions. Transactions involving financial and corporate end-users are not exempt from trading on existing stock or futures exchanges. We should similarly not exempt standard customer swap trades from trading on exchanges or execution facilities. I believe that end-users should get the benefit of the sunlight and better pricing that comes with transparency.

In addition to bringing transparency to the OTC derivatives marketplace, we must respond to last year's crisis by lowering the risks that these markets present to the entire financial system. Last year's crisis taught us that American and global financial institutions had not only become what some called too big to fail, but also too interconnected to fail. Derivatives dealers have become interconnected with literally thousands of counterparties located in every sector of our economy and in every state in our nation.

In that regard, all standard OTC transactions should be required to be cleared by robustly regulated central counterparties. Today, trades mostly remain on the books of large complex financial institutions, which internalize the volatile risks of their positions. These institutions 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 standard swaps off the books of large financial institutions and into well-regulated clearinghouses.

I believe that we need to bring as many standard transactions to central clearinghouses as possible, regardless of what type of party stands on either side of the trade. This should include interbank transactions as well as transactions with financial and corporate end-users. To accommodate corporations' concerns about posting margin, they, as well as other end-users, should be permitted to enter into individualized credit arrangements with the clearing members that transact on their behalf. Regulators would not require a particular form of collateral – end-users would simply be required to work with the clearing firm to determine an appropriate credit arrangement. In this way, we would not leave an entire class of transactions interconnected and on the books of the major financial institutions.

If Congress decides to exempt end-users from a clearing requirement, that exception should be narrowly defined to include only nonfinancial entities that use swaps as an incidental part of their business to hedge actual commercial risks. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system.

The question before Congress of whether to exempt end-user transactions from clearing is separable from the issue of whether those transactions should be exempt from a transparent trading requirement. Exchanges and trading venues are where buyers and sellers meet, prices are negotiated and discovered, trades are affirmed and transaction prices and volumes are reported in a timely manner. Clearinghouses are different from trading venues in that they help lower risk to the parties after they enter into the trade. Thus, Congress could require all standard transactions to be brought to transparent trading venues even if Congress were to leave the choice of clearing to the end-user.

Over the course of the past year, I have testified many times on the need to subject all standardized contracts to both trading and clearing requirements. To accomplish this, I have advocated that the CFTC and the SEC have the clear authority to determine which contracts are subject to a clearing requirement as well as to use market mechanisms to help make those determinations. The goal must be to establish a clearing requirement that covers the greatest possible number of contracts as well as the greatest possible number of transactions in those contracts.

But, covering a large number of contracts does not ensure that transactions of those contracts would be included. Thus, the important debate is over exemptions from regulation for transactions with particular parties. Derivatives reform will be less effective if legislation includes broad exemptions for transactions with financial and

corporate end-users. I am hopeful that we will be able to work with Congress in the coming weeks and months to narrow exceptions and enact comprehensive regulation over the OTC derivatives marketplace.

History will judge us based upon how we respond to this call to action. I believe that much needs to change to protect the American public – both in the markets that are currently regulated and in the over-the-counter markets. We must ensure that last year's crisis was the last.

Thank you for inviting me to speak today. I will now take any questions that you may have. I ask that members of the press save their questions for after today's event.