



## **Commodity Futures Trading Commission**

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# **Remarks**

## **Remarks of Chairman Gary Gensler, OTC Derivatives Reform, American Bar Association, Committee on Derivatives and Futures Law**

**January 29, 2010**

Good afternoon. I thank the American Bar Association's Committee on Derivatives and Futures Law for inviting me to speak today. This morning, I visited some friends that I made a couple years ago in Immokalee, which is about an hour east of here. Immokalee is Florida's largest farm working community. About 95 percent of the tomatoes you eat in the United States between October and June come from Florida, with many of them grown in Immokalee.

The migrant workers who pick and package the tomatoes earn less in a year than what some in this room may bill in a day. They sleep in metal trailers with up to ten other workers, hoping that each morning they will be selected to go into the field and earn a little money. A couple of years ago, I met the people of Immokalee and was asked to help in their efforts for better wages and working conditions. It might not sound like much, but together we negotiated an additional penny per pound for tomatoes sold to Burger King. Still, they have struggled day after day to support themselves and their families.

In the last two years, even as this community has made further strides to improve living and working conditions, they have been hit by an unrelated setback: the global financial crisis. Derivatives and Wall Street might seem quite removed from people's everyday lives, but the struggles of the people of Immokalee and so many other communities around this country are reminders that our work in Washington and our debates about reform have real effects throughout our great land. The proud, hardworking people in Immokalee do not use derivatives markets. Like so many Americans, though, their lives have been affected by the steep economic recession born out of the financial crisis. Their lives have been affected by the failure to contain the risks created by Wall Street.

Wall Street's interests do not necessarily reflect the broader interests of the American public. In maximizing their profits, banks are fulfilling their fiduciary duty to shareholders, but they do not owe a similar duty to taxpayers. Many of these banks

have opposed essential components of reform. Now, I know that some of these banks may be represented by some of the lawyers in this room. On their behalf, some of you may have argued that particular regulations would hurt not just Wall Street, but the American public. I've heard many of these arguments, both over the last year and during earlier debates. While they are often well-articulated, I, for one, come to different conclusions. What's good for Wall Street is often not what's good for the American public. Thus, as we vigorously advocate for transparency and regulation in the derivatives markets, these positions may be at odds with what some of you advocate on behalf of your clients. But, as the saying goes, where we stand on a matter is often influenced by where we sit.

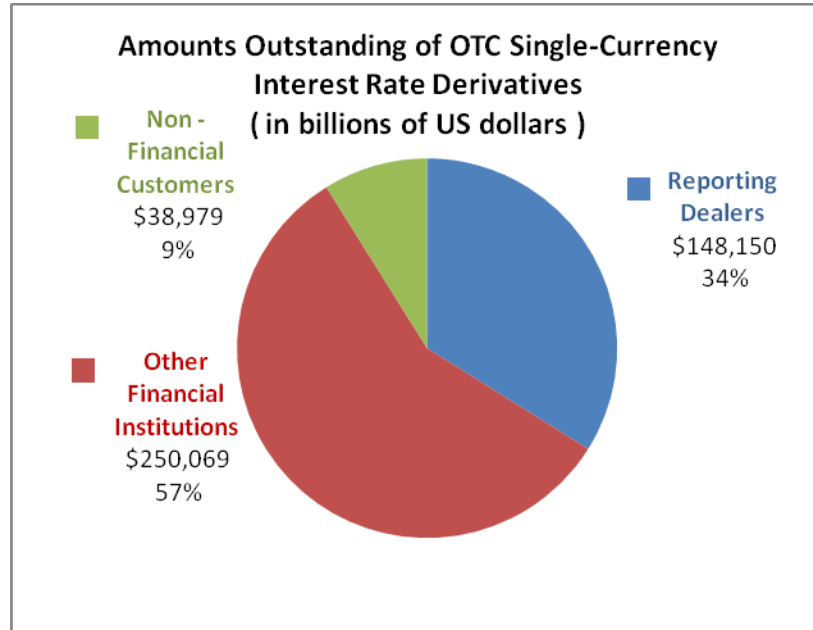
It took about 60 or 70 years after the first derivatives, called "futures," traded before they were regulated. Nearly fifty years later, in 1981, new products emerged called "over-the-counter derivatives." Some of you may have advised clients when the first over-the-counter derivatives were transacted. Nearly 30 years later, these products remain largely unregulated.

Now, the Administration and Congress are in the middle of a new historic effort to enact broad derivatives reform. Many of the people in this room, as well as your clients, have publicly expressed support for reform. So now it's time to get down to the details. As everyone here knows, ultimately, the devil is in the details.

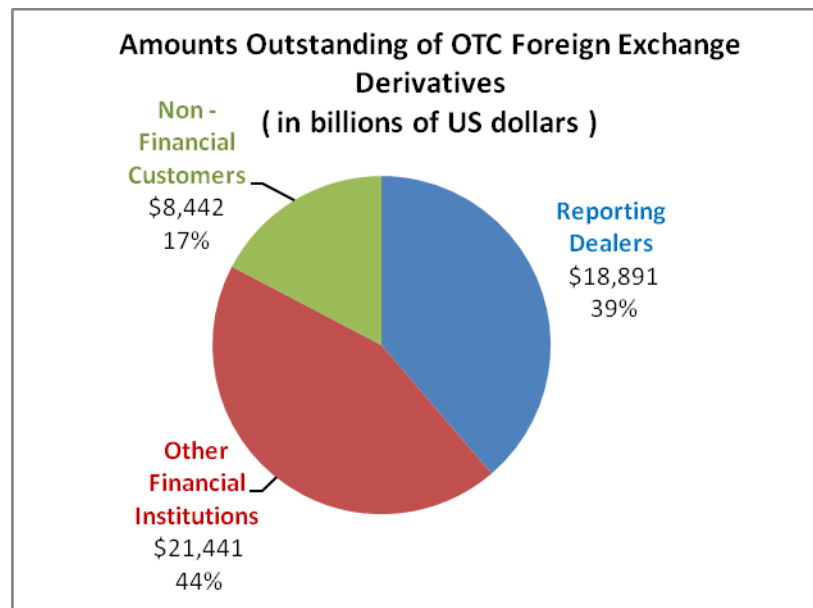
The most critical details being debated relate to transparency and clearing, and, specifically, which portion of the over-the-counter derivatives market should be covered. First, so that corporations can effectively hedge their risk, tailored, or customized, products should be permitted to trade bilaterally, with the dealers being regulated for these transactions. Standardized products, however, should be moved into transparent trading venues and regulated clearinghouses. There are various estimates as to the size of the standardized market. One Wall Street CEO testified to the Financial Crisis Inquiry Commission earlier this month that he believed that 75-80 percent of transactions are standardized enough to be cleared.. I have heard other estimates that two-thirds to three-quarters of the markets are standard. Whatever the proportion of the market, we must bring all standardized products into trading platforms and regulated clearinghouses.

Second, we must address what has moved to the center of the derivatives reform debate: the end-user exemption. I believe that all standardized transactions, regardless of whether they are between two Wall Street banks or between a bank and a corporation, should be subject to a trading requirement and a clearing requirement. Many in this room and your clients have urged Congress to exempt particular classes of transactions. I have heard the argument that end-user transactions comprise only a small part of the standardized markets, and thus might not need regulation. I will note, however, that statistics from the Bank for International Settlements released last month indicate that dealer-to-dealer transactions comprise 40 percent or less of the market in most contracts. Thus, an end-user exemption could leave up to 60 percent of standardized transactions out of the transparency and clearing requirements.

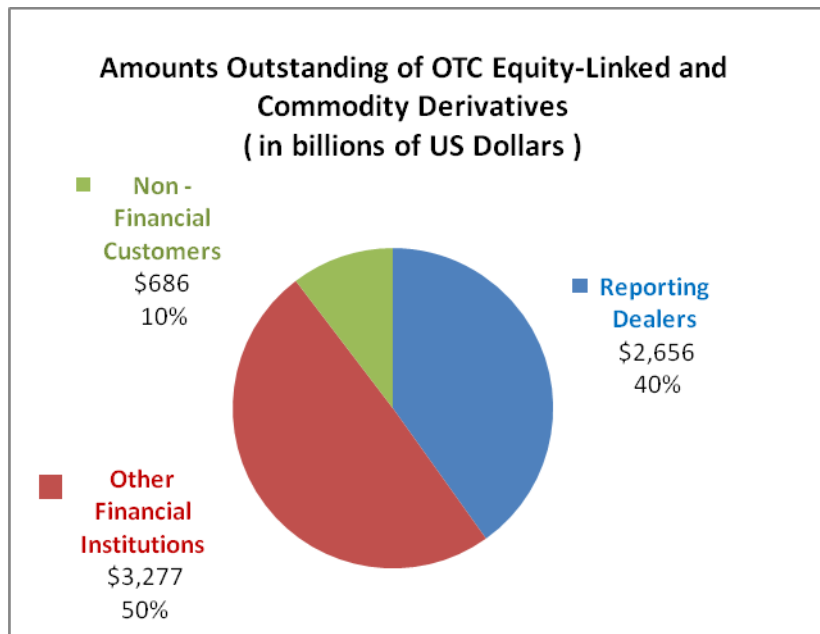
For example, in the single-currency interest rate markets, dealer-to-dealer transactions comprise only 34 percent of the notional value.



In over-the-counter foreign exchange derivatives, dealer-to-dealer transactions comprise only 39 percent of the market.



In the equity-linked and commodity derivatives markets, dealer-to-dealer transactions comprise only 40 percent of the notional value.



Depending upon how this debate comes out, some portion of the transactions between dealers and their financial customers could be covered, but a large portion of the derivatives market would lack the benefit of the transparency and risk reduction we so desperately need to bring.

Now I will discuss in more detail the reforms I believe are necessary to protect the public and promote fair and efficient markets. I believe that financial reform will be incomplete if we do not bring public transparency to the over-the-counter marketplace. It is not enough just to bring transparency to the regulators. An opaque market, concentrated with a small number of financial institutions, contributed to a financial system brought to the brink of collapse. President Franklin Roosevelt recognized in the 1930s that transparency, a key to market-based reform, was critical to ensuring that a market functions well. We now must bring a similar level of transparency to the derivatives markets.

The more transparent a marketplace is, the more liquid it is. The more transparent a marketplace is, the more competitive it is. And the more transparent a marketplace is, the lower the costs for hedgers, borrowers and, ultimately, their customers. The best way to bring transparency is through regulated trading facilities and exchanges. Such centralized trading venues not only bring greater transparency, but increase competition in the markets by encouraging market-making and the provision of liquidity by a greater number of participants. A greater number of market makers brings better pricing and lowers risk to the system.

I understand that such a transparency requirement is one of the things that Wall Street likes the least. After all, requiring banks to bring their transactions to trading venues would shift the information advantage from a small group of derivative dealers on Wall Street to the broader market. It is only dealers that benefit from keeping standardized trades off of transparent trading venues, because dealers can internalize the transaction

information. The banks and dealers profit from access to trading information while businesses, municipalities, consumers and others pay the costs.

Most of you in this room probably invest in the stock market. Imagine if the stock markets functioned the same way as the over-the-counter derivatives markets. Would you put 100 shares of a stock into your 401(k) with no knowledge of where the market prices the stocks? Similarly, we should require that standardized derivatives be traded on regulated trading venues where all market participants get to see the pricing.

Further, clearinghouses would be far more able to price the risk of over-the-counter derivatives with the benefit of transparent trading markets. If clearinghouses are unable to see the posted price of transactions, they will be less able to mark to market the derivatives they clear and, thus, less able to manage their risk and protect the public.

Some on Wall Street have suggested that they could support a clearing requirement, but see no need for a transparency requirement. But make no mistake: transparency is an absolutely essential component of reform.

While transparency would bring better pricing, we must also lower risk in the over-the-counter markets. Dealers should be required to bring their standardized derivatives transactions to regulated clearinghouses once they are arranged. These transactions currently stay on the books of the dealers often for years. At the same time, these banks also engage in many other businesses, such as lending, underwriting, asset management, securities trading and deposit-taking. Why leave these transactions on the books of the banks when so many people feel they are possibly “too big to fail?” Central clearing would greatly reduce interconnectedness between Wall Street banks, their customers and the economy.

Some corporations have expressed concerns regarding posting the collateral required to clear a contract. While this is a legitimate public policy debate, I believe that the public is best served by lowering risk to the system as a whole. An exemption from clearing for this large class of transactions would allow banks to keep significant risk on their books – risk that could reverberate throughout the entire financial system if a bank failed. Further, dealers charge corporations for credit extensions when the corporations do not post margin.

If Congress ultimately determines that commercial end-users should be exempt from a clearing requirement, the exemptions should be narrow. We should not exempt any entity other than those nonfinancial entities hedging their risk. As illustrated by the BIS data, transactions with non-dealer financial firms make up 57 percent of the interest rate derivatives markets. Hedge funds and other financial firms should not be exempt from a clearing requirement.

Further, any commercial end-user exception from clearing should not bring along an exemption from a transparency requirement. Commercial end-users have raised concerns about posting margin if they are required to clear their transactions. There is no such concern with the trading requirement as long as the trading requirement can be separated from the clearing requirement. In fact, most commercial end-users would like greater transparency than Wall Street currently provides.

Fortunately, twenty-first century technology allows separation of trading from clearing, if that's what Congress decides to do. Trading platforms already exist that allow market participants to use credit filters to avoid central clearing and trade bilaterally with pre-selected preferred counterparties. We can harness this technology for the entire standardized over-the-counter derivatives marketplace.

I'd like to again thank you for inviting me to speak today. While I know our opinions may differ, I appreciate your willingness to listen to me. We live in a great democracy, and we all have an opportunity to make our cases known. Some of your clients may oppose parts of the critical reform I have outlined today, but I will keep fighting for these necessary changes. These reforms do not affect just Wall Street and corporate America. While the people of Immokalee and so many other communities in this country may not purchase swaps, their living standards and working standards will be affected by the results of this debate.

Thank you, and I look forward to your questions.