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BEFORE THE
U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
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Good morning Chairman Johnson, Ranking Member Crapo and members of the Committee. I thank you for inviting me to today's hearing on implementation of Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) swaps market reforms. I am pleased to testify along with my fellow regulators. I also want to thank the CFTC Commissioners and staff for their hard work and dedication.

The New Era of Swaps Market Reform

This hearing is occurring at an historic time in the markets. The CFTC now oversees the derivatives marketplace – across both futures and swaps. The marketplace is increasingly shifting to implementation of the common-sense rules of the road for the swaps market that Congress included in the Dodd-Frank Act.

For the first time, the public is benefiting from seeing the price and volume of each swap transaction. This post-trade transparency builds upon what has worked for decades in

the futures and securities markets. The new swaps market information is available free of charge on a website, like a modern-day ticker tape.

For the first time, the public will benefit from the greater access to the markets and the risk reduction that comes with central clearing. Required clearing of interest rate and credit index swaps between financial entities begins next month.

For the first time, the public will benefit from specific oversight of swap dealers. As of today, 71 swap dealers are provisionally registered. They are subject to standards for sales practices, recordkeeping and business conduct to help lower risk to the economy and protect the public from fraud and manipulation. The full list of registered swap dealers is on the CFTC's website, and we will update it as more entities register.

An earlier economic crisis led President Roosevelt and Congress to enact similar common-sense rules of the road for the futures and securities markets. I believe these critical reforms of the 1930s have been at the foundation of our strong capital markets and many decades of economic growth.

In the 1980s, the swaps market emerged. Until now, though, it had lacked the benefit of rules to promote transparency, lower risk and protect the public, rules that we have come to depend upon in the securities and futures markets. What followed was the 2008 financial crisis. Eight million American jobs were lost. In contrast, the futures market, supported by earlier reforms, weathered the financial crisis.

Congress and President Obama responded to the worst economic crisis since the Great Depression and carefully crafted the Dodd-Frank swaps provisions. They borrowed from what has worked best in the futures market for decades: transparency, clearing and oversight of intermediaries.

The CFTC has largely completed swaps market rulewriting, with 80 percent behind us. On October 12, the CFTC and Securities and Exchange Commission's (SEC) foundational definition rules went into effect. This marked the new era of swaps market reform.

The CFTC is seeking to consider and finalize the remaining Dodd-Frank swaps reforms this year. In addition, as Congress directed the CFTC to do, I believe it's critical that we continue our efforts to put in place aggregate speculative position limits across futures and swaps on physical commodities.

The agency has completed each of our reforms with an eye toward ensuring that the swaps market works for end-users, America's primary job providers. It's the end-users in the non-financial side of our economy that provide 94 percent of private sector jobs.

The CFTC's swaps market reforms benefit end-users by lowering costs and increasing access to the markets. They benefit end-users through greater transparency – shifting information from Wall Street to Main Street. Following Congress' direction, end-

users are not required to bring swaps into central clearing. Further, the Commission's proposed rule on margin provides that end-users will not have to post margin for uncleared swaps. Also, non-financial companies, other than those genuinely making markets in swaps, will not be required to register as swap dealers. Lastly, when end-users are required to report their transactions, they are given more time to do so than other market participants.

Congress also authorized the CFTC to provide relief from the Dodd-Frank Act's swaps reforms for certain electricity and electricity-related energy transactions between rural electric cooperatives and federal, state, municipal and tribal power authorities. Similarly, Congress authorized the CFTC to provide relief for certain transactions on markets administered by regional transmission organizations and independent system operators. The CFTC is looking to soon finalize two exemptive orders related to these various transactions, as Congress authorized.

The CFTC has worked to complete the Dodd-Frank reforms in a deliberative way – not against a clock. We have been careful to consider significant public input, as well as the costs and benefits of each rule. CFTC Commissioners and staff have met more than 2,000 times with members of the public, and we have held 22 public roundtables. The agency has received more than 39,000 comment letters on matters related to reform. Our rules also have benefited from close consultation with domestic and international regulators and policymakers.

Throughout this process, the Commission has sought input from market participants on appropriate schedules to phase in compliance with swaps reforms. Now, over two-and-a-half years since Dodd-Frank passed and with 80 percent of our rules finalized, the market is moving to implementation. Thus, it's the natural order of things that market participants have questions and have come to us for further guidance. The CFTC welcomes inquiries from market participants, as some fine-tuning is expected. As it is sometimes the case with human nature, the agency receives many inquiries as compliance deadlines approach.

My fellow commissioners and I, along with CFTC staff, have listened to market participants and thoughtfully sorted through issues as they were brought to our attention, as we will continue to do.

I now will go into further detail on the Commission's swaps market reform efforts.

Transparency – Lowering Cost and Increasing Liquidity, Efficiency, Competition

Transparency – a longstanding hallmark of the futures market – both pre- and post-trade – lowers costs for investors, consumers and businesses. It increases liquidity, efficiency and competition. A key benefit of swaps reform is providing this critical pricing information to businesses and other end-users across this land that use the swaps market to lock in a price or hedge a risk.

As of December 31, 2012, provisionally registered swap dealers are reporting in real time their interest rate and credit index swap transactions to the public and to regulators through swap data repositories. These are some of the same products that were at the center of the financial crisis. Building on this, swap dealers will begin reporting swap transactions in equity, foreign exchange and other commodity asset classes on February 28. Other market participants will begin reporting April 10.

With these transparency reforms, the public and regulators now have their first full window into the swaps marketplace.

Time delays for reporting currently range from 30 minutes to longer, but will generally be reduced to 15 minutes this October for interest rate and credit index swaps. For other asset classes, the time delay will be reduced next January. After the CFTC completes the block rule for swaps, trades smaller than a block will be reported as soon as technologically practicable.

To further enhance liquidity and price competition, the CFTC is working to finish the pre-trade transparency rules for swap execution facilities (SEFs), as well as the block rule for swaps. SEFs would allow market participants to view the prices of available bids and offers prior to making their decision on a transaction. These rules will build on the democratization of the swaps market that comes with the clearing of standardized swaps.

Clearing – Lowering Risk and Democratizing the Market

Since the late 19th century, clearinghouses have lowered risk for the public and fostered competition in the futures market. Clearing also has democratized the market by fostering access for farmers, ranchers, merchants, and other participants.

A key milestone was reached in November 2012 with the CFTC's adoption of the first clearing requirement determinations. The vast majority of interest rate and credit default index swaps will be brought into central clearing. This follows through on the U.S. commitment at the 2009 G-20 meeting that standardized swaps should be brought into central clearing by the end of 2012. Compliance will be phased in throughout this year. Swap dealers and the largest hedge funds will be required to clear March 11, and all other financial entities follow June 10. Accounts managed by third party investment managers and ERISA pension plans have until September 9 to begin clearing.

Consistent with the direction of Dodd-Frank, the Commission in the fall of 2011 adopted a comprehensive set of rules for the risk management of clearinghouses. These final rules were consistent with international standards, as evidenced by the Principles for Financial Market Infrastructures (PFMIs) consultative document that had been published by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS-IOSCO).

In April of 2012, CPSS-IOSCO issued the final PFMIs. The Commission's clearinghouse risk management rules cover the vast majority of the standards set forth in the

final PFMI. There are a small number of areas where it may be appropriate to augment our rules to meet those standards, particularly as it relates to systemically important clearinghouses. I have directed staff to work expeditiously to recommend the necessary steps so that the Commission may implement any remaining items from the PFMI not yet incorporated in our clearinghouse rules. I look forward to the Commission considering action on this in 2013.

I expect that soon we will complete a rule to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement. This year, the CFTC also will be considering possible clearing determinations for other commodity swaps, including energy swaps.

Swap Dealer Oversight - Promoting Market Integrity and Lowering Risk

Comprehensive oversight of swap dealers, a foundational piece of Dodd-Frank, will promote market integrity and lower risk to taxpayers and the rest of the economy. Congress wanted end-users to continue benefitting from customized swaps (those not brought into central clearing) while being protected through the express oversight of swap dealers. In addition, Dodd-Frank extended the CFTC's existing oversight of previously regulated intermediaries to include their swaps activity. Such intermediaries have historically included futures commission merchants, introducing brokers, commodity pool operators, and commodity trading advisors.

As the result of CFTC rules completed in the first half of last year, 71 swap dealers are now provisionally registered. This initial group of dealers includes the largest domestic and international financial institutions dealing in swaps with U.S. persons. It includes the 16 institutions commonly referred to as the G16 dealers. Other entities are expected to register over the course of this year once they exceed the de minimis threshold for swap dealing activity.

In addition to reporting trades to both regulators and the public, swap dealers will implement crucial back office standards that lower risk and increase market integrity. These include promoting the timely confirmation of trades and documentation of the trading relationship. Swap dealers also will be required to implement sales practice standards that prohibit fraud, treat customers fairly and improve transparency. These reforms are being phased in over the course of this year.

The CFTC is collaborating closely domestically and internationally on a global approach to margin requirements for uncleared swaps. We are working along with the Federal Reserve, the other U.S. banking regulators, the SEC and our international counterparts on a final set of standards to be published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). The CFTC's proposed margin rules excluded non-financial end-users from margin requirements for uncleared swaps. We have been advocating with global regulators for an approach consistent with that of the CFTC. I would anticipate that the CFTC, in consultation with

European regulators, would take up a final margin rules, as well as related rules on capital, in the second half of this year.

Following Congress' mandate, the CFTC also is working with our fellow domestic financial regulators to complete the Volcker Rule. In adopting the Volcker rule, Congress prohibited banking entities from proprietary trading, an activity that may put taxpayers at risk. At the same time, Congress permitted banking entities to engage in certain activities, such as market making and risk mitigating hedging. One of the challenges in finalizing a rule is achieving these multiple objectives.

International Coordination on Swaps Market Reform

In enacting financial reform, Congress recognized the basic lessons of modern finance and the 2008 crisis. During a default or crisis, risk knows no geographic border. Risk from our housing and financial crisis contributed to economic downturns around the globe. Further, if a run starts on one part of a modern financial institution, almost regardless of where it is around the globe, it invariably means a funding and liquidity crisis rapidly spreads and infects the entire consolidated financial entity.

This phenomenon was true with the overseas affiliates and operations of AIG, Lehman Brothers, Citigroup, and Bear Stearns.

AIG Financial Products, for instance, was a Connecticut subsidiary of New York insurance giant that used a French bank license to basically run its swaps operations out of Mayfair in London. Its collapse nearly brought down the U.S. economy.

Last year's events of JPMorgan Chase, where it executed swaps through its London branch, are a stark reminder of this reality of modern finance. Though many of these transactions were entered into by an offshore office, the bank here in the United States absorbed the losses. Yet again, this was a reminder that in modern finance, trades booked offshore by U.S. financial institutions should not be confused with keeping that risk offshore.

Failing to incorporate these basic lessons of modern finance into the CFTC's oversight of the swaps market would fall short of the goals of Dodd-Frank reform. It would leave the public at risk.

More specifically, I believe that Dodd-Frank reform applies to transactions entered into by overseas branches of U.S. entities with non-U.S. persons, as well as between overseas affiliates guaranteed by U.S. entities. Failing to do so would mean American jobs and markets may move offshore, but, particularly in times of crisis, risk would come crashing back to our economy.

Similar lessons of modern finance were evident, as well, with the collapse of the hedge fund Long-Term Capital Management in 1998. It was run out of Connecticut, but its \$1.2 trillion swaps were booked in its Cayman Islands affiliate. The risk from those

activities, as the events of the time highlighted, had a direct and significant effect here in the United States.

The same was true when Bear Stearns in 2007 bailed out two of its sinking hedge fund affiliates, which had significant investments in subprime mortgages. They both were organized offshore. This was just the beginning of the end, as within months, the Federal Reserve provided extraordinary support for the failing Bear Stearns.

We must thus ensure that collective investment vehicles, including hedge funds, that either have their principle place of business in the United States or are directly or indirectly majority owned by U.S. persons are not able to avoid the clearing requirement – or any other Dodd-Frank requirement – simply due to how they might be organized.

We are hearing, though, that some swap dealers may be promoting to hedge funds an idea to avoid required clearing, at least during an interim period from March until July. I would be concerned if, in an effort to avoid clearing, swap dealers route to their foreign affiliates trades with hedge funds organized offshore, even though such hedge funds' principle place of business was in the United States or they are majority owned by U.S. persons. The CFTC is working to ensure that this idea does not prevail and develop into a practice that leaves the American public at risk. If we don't address this, the P.O boxes may be offshore, but the risk will flow back here.

Congress understood these issues and addressed this reality of modern finance in Section 722(d) of the Dodd-Frank Act, which states that swaps reforms shall not apply to activities outside the United States unless those activities have “a direct and significant connection with activities in, or effect on, commerce of the United States.” Congress provided this provision solely for swaps under the CFTC’s oversight and provided a different standard for securities-based swaps under the SEC’s oversight.

To give financial institutions and market participants guidance on 722(d), the CFTC last June sought public consultation on its interpretation of this provision. The proposed guidance is a balanced, measured approach, consistent with the cross-border provisions in Dodd-Frank and Congress’ recognition that risk easily crosses borders.

Pursuant to Commission guidance, foreign firms that do more than a de minimis amount of swap-dealing activity with U.S. persons would be required to register with the CFTC within about two months after crossing the de minimis threshold. A number of international financial institutions are among the 71 swap dealers that are provisionally registered with the CFTC.

Where appropriate, we are committed to permitting, foreign firms and, in certain circumstances, overseas branches and guaranteed affiliates of U.S. swap dealers, to comply with Dodd-Frank through complying with comparable and comprehensive foreign regulatory requirements. We call this substituted compliance.

For foreign swap dealers, we would allow such substituted compliance for requirements that apply across a swap dealer's entity, as well as for certain transaction-level requirements when facing overseas branches of U.S. entities and overseas affiliates guaranteed by U.S. entities. Entity-level requirements include capital, chief compliance officer and swap data recordkeeping. Transaction-level requirements include clearing, margin, real-time public reporting, trade execution, trading documentation and sales practices.

When foreign swaps dealers transact with a U.S. person, though, compliance with Dodd-Frank is required.

To assist foreign swap dealers with Dodd-Frank compliance, the CFTC recently finalized an exemptive order that applies until mid-July 2013. This Final Order for foreign swap dealers incorporates many suggestions from the ongoing consultation on cross-border issues with foreign regulatory counterparts and market participants. For instance, the definition of "U.S. person" in the Order benefited from the comments in response to the July 2012 proposal.

Under this Final Order, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, the Order provides time-limited relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by U.S. entities, as well as with foreign branches of U.S. swap dealers.

The Final Order provides time for the Commission to continue working with foreign regulators as they implement comparable swaps reforms and as the Commission considers substituted compliance determinations for the various foreign jurisdictions with entities that have registered as swap dealers under Dodd-Frank.

The CFTC will continue engaging with our international counterparts through bilateral and multilateral discussions on reform and cross-border swaps activity. Just last week, SEC Chairman Walter and I had a productive meeting with international market regulators in Brussels.

Given our different cultures, political systems and legislative mandates some differences are unavoidable, but we've made great progress internationally on an aligned approach to reform. The CFTC is committed to working through any instances where we are made aware of a conflict between U.S. law and that of another jurisdiction.

Customer Protection

Dodd-Frank included provisions directing the CFTC to enhance the protection of swaps customer funds. While it was not a requirement of Dodd-Frank, in 2009 the CFTC also reviewed our existing customer protection rules for futures market customers. As a result, a number of our customer protection enhancements affect both futures and swaps

market customers. I would like to review our finalized enhancements, as well as an important customer protection proposal.

The CFTC's completed amendments to rule 1.25 regarding the investment of customer funds benefit both futures and swaps customers. The amendments include preventing in-house lending of customer money through repurchase agreements. The CFTC's gross margining rules for futures and swaps customers require clearinghouses to collect margin on a gross basis. Futures commission merchants (FCMs) are no longer able to offset one customer's collateral against another or to send only the net to the clearinghouse.

Swaps customers further benefit from the new so-called LSOC (legal segregation with operational comingling) rules, which ensure their money is protected individually all the way to the clearinghouse.

The Commission also worked closely with market participants on new rules for customer protection adopted by the self-regulatory organization (SRO), the National Futures Association. These include requiring FCMs to hold sufficient funds for U.S. foreign futures and options customers trading on foreign contract markets (in Part 30 secured accounts). Starting last year, they must meet their total obligations to customers trading on foreign markets computed under the net liquidating equity method. In addition, FCMs must maintain written policies and procedures governing the maintenance of excess funds in customer segregated and Part 30 secured accounts. Withdrawals of 25 percent or more would

necessitate pre-approval in writing by senior management and must be reported to the designated SRO and the CFTC.

These steps were significant, but market events have further highlighted that the Commission must do everything within our authorities and resources to strengthen oversight programs and the protection of customers and their funds.

In the fall of 2012, the Commission sought public comment on a proposal to further enhance the protection of customer funds.

The proposal, which the CFTC looks forward to finalizing this year, would strengthen the controls around customer funds at FCMs. It would set new regulatory accounting requirements and would raise minimum standards for independent public accountants who audit FCMs. And it would provide regulators with daily direct electronic access to the FCMs' bank and custodial accounts for customer funds. Last week, the CFTC held a public roundtable on this proposal, the third roundtable focused on customer protection.

Further, the CFTC intends to finalize a rule this year on segregation for uncleared swaps.

Benchmark Interest Rates

I'd like to now turn to the three cases the CFTC brought against Barclays, UBS and RBS for manipulative conduct with respect to the London Interbank Offered Rate (LIBOR) and other benchmark interest rate submissions. The reason it's important to focus on these matters is not because there were \$2.5 billion in fines, though the U.S. penalties against these three banks of more than \$2 billion were significant. What this is about is the integrity of the financial markets. When a reference rate, such as LIBOR – central to borrowing, lending and hedging in our economy – has been so readily and pervasively rigged, it's critical that we discuss how to best change the system. We must ensure that reference rates are honest and reliable reflections of observable transactions in real markets.

The three cases shared a number of common traits. Foremost, at each institution the misconduct spanned multiple years, involved offices in multiple cities around the globe, included numerous people, and affected multiple benchmark rates and currencies. In each case, there was evidence of collusion among banks. In both the UBS and RBS cases, one or more inter-dealer brokers were asked to paint false pictures to influence submissions of other banks, i.e., to spread the falsehoods more widely. At Barclays and UBS, the banks also were reporting falsely low borrowing rates in an effort to protect their reputation.

Why does this matter?

The derivatives marketplace that the CFTC oversees started about 150 years ago. Futures contracts initially were linked to physical commodities, like corn and wheat. Such clear linkage ultimately comes from the ability of farmers, ranchers and other market

participants to physically deliver the commodity at the expiration of the contract. As the markets evolved, cash-settled contracts emerged, often linked to markets for financial commodities, like the stock market or interest rates. These cash-settled derivatives generally reference indices or benchmarks.

Whether linked to physical commodities or indices, derivatives – both futures and swaps – should ultimately be anchored to observable prices established in real underlying cash markets. And it's only when there are real transactions entered into at arm's length between buyers and sellers that we can be confident that prices are discovered and set accurately.

When market participants submit for a benchmark rate that lacks observable underlying transactions, even if operating in good faith, they may stray from what real transactions would reflect. When a benchmark is separated from real transactions, it is more vulnerable to misconduct.

Today, LIBOR is the reference rate for 70 percent of the U.S. futures market, most of the swaps market and nearly half of U.S. adjustable rate mortgages. It's embedded in the wiring of our financial system.

The challenge we face is that the market for interbank, unsecured borrowing has largely diminished over the last five years. Some say that it is essentially nonexistent. In

2008, Mervyn King, the governor of the Bank of England, said of Libor: “It is, in many ways, the rate at which banks do not lend to each other.”

The number of banks willing to lend to one another on such terms has been sharply reduced because of economic turmoil, including the 2008 global financial crisis, the European debt crisis that began in 2010, and the downgrading of large banks’ credit ratings. In addition, there have been other factors that have led to unsecured, interbank lending drying up, including changes to Basel capital rules and central banks providing funding directly to banks.

Fortunately, much work is occurring internationally to address these issues. I want to commend the work of Martin Wheatley and the UK Financial Services Authority (FSA) on the “Wheatley Review of LIBOR.” Additionally, the CFTC and the FSA are co-chairing the International Organization of Securities Commissions (IOSCO) Task Force that is developing international principles for benchmarks and examining best mechanisms or protocols for transition, if needed. On January 11, the IOSCO Task Force published the *Consultation Report on Financial Benchmarks*.

The consultation report said: “The Task Force is of the view that a benchmark should as a matter of priority be anchored by observable transactions entered into at arm’s length between buyers and sellers in order for it to function as a credible indicator of prices, rates or index values.” It went on to say: “However, at some point, an insufficient level of actual

transaction data raises concerns as to whether the benchmark continues to reflect prices or rates that have been formed by the competitive forces of supply and demand.”

Among the questions for the public in the report are the following:

- What are the best practices to ensure that benchmark rates honestly reflect market prices?
- What are best practices for benchmark administrators and submitters?
- What factors should be considered in determining whether a current benchmark’s underlying market is sufficiently robust? For instance, what is an insufficient level of actual transaction activity?
- And what are the best mechanisms or protocols to transition from an unreliable or obsolete benchmark?

On February 20, we are holding a public roundtable in London. On February 26, the CFTC is hosting a second roundtable to gather input from market participants and other interested parties. A final report incorporating this crucial public input will be published this spring.

Resources

The CFTC’s hardworking team of 690 is less than 10 percent more in numbers than at our peak in the 1990s. Yet since that time, the futures market has grown five-fold, and the

swaps market is eight times larger than the futures market.

Market implementation of swaps reforms means additional resources for the CFTC are all the more essential. Investments in both technology and people are needed for effective oversight of these markets by regulators – like having more cops on the beat.

Though data has started to be reported to the public and to regulators, we need the staff and technology to access, review and analyze the data. Though 71 entities have registered as new swap dealers, we need people to answer their questions and work with the NFA on the necessary oversight to ensure market integrity. Furthermore, as market participants expand their technological sophistication, CFTC technology upgrades are critical for market surveillance and to enhance customer fund protection programs.

Without sufficient funding for the CFTC, the nation cannot be assured this agency can closely monitor for the protection of customer funds and utilize our enforcement arm to its fullest potential to go after bad actors in the futures and swaps markets. Without sufficient funding for the CFTC, the nation cannot be assured that this agency can effectively enforce essential rules that promote transparency and lower risk to the economy.

The CFTC is currently funded at \$207 million. To fulfill our mission for the benefit of the public, the President requested \$308 million for fiscal year 2013 and 1,015 full-time employees.

Thank you again for inviting me today, and I look forward to your questions.