

STATEMENT OF GARY GENSLER
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
HOUSE COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK
MANAGEMENT
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Good morning Chairman Boswell, Ranking Member Moran and members of the Subcommittee. Thank you for inviting me to testify regarding the implementation of changes to the Commodity Exchange Act contained in the 2008 Farm Bill. I am please to testify on behalf of the Commodity Futures Trading Commission (CFTC). I will focus my testimony today on three principal issues: the CFTC's use of existing authorities to fulfill our mission, the need for additional authorities to oversee the over-the-counter derivatives marketplace and the need for additional resources to best protect the American public.

CFTC Regulatory Regime

Before I get to the three topic areas outlined above, I will take a moment to discuss the CFTC's oversight of the futures markets. Futures have traded in the United States since the Civil War, when farmers and grain merchants came together and created a new type of marketplace. It was not until 60 years later that the Congress first passed legislation to regulate these markets. In 1922, Congress passed the Grain Futures Act that first provided a regulatory structure over

futures and established the federal authority that eventually became the CFTC. In the midst of the Great Depression, Congress passed the Commodity Exchange Act to strengthen that regulatory structure.

The CFTC ensures that futures and commodity options exchanges have procedures to ensure that trading is fair and orderly and free from fraud, manipulation and other abuses. Exchanges are where buyers and sellers meet and enter into a transaction. Specifically, the CFTC oversees 14 designated contract markets (DCMs) and one exempt commercial market (ECM) that lists a contract that the Commission determined to be a significant price discovery contract (SPDC). The CFTC also oversees 13 clearinghouses, which enter the picture only after two counterparties enter into the transaction. After two parties agree to a trade, a derivatives clearing organization (DCO) takes on the risk that either counterparty to the trade may fail to meet its obligations under the contract for the duration of the contract. Centralized clearing has helped prevent systemic risks for decades in both calm markets and in the stormiest of markets, such as during the 2008 financial crisis.

The CFTC has wide-ranging transparency programs designed to provide as much information about commodity futures markets and trading to the American public as possible under current law. The agency also has broad surveillance powers to police the markets for fraud, manipulation and other abuses.

The CFTC currently oversees 66,187 registrants, including 51,921 salespersons, 1,277 commodity pool operators, 2,568 commodity trading advisors, 7,114 floor brokers, 1,447 floor traders, 166 futures commission merchants and 1,694 introducing brokers.

The total size of the markets we regulate, measured in notional value, was more than \$33 trillion in 2009. The CFTC oversaw 2,051 actively traded contracts with a volume of nearly three billion contracts traded.

Existing Authorities

The Congress gave the CFTC broad authorities to oversee and police the regulated futures and options markets in the Commodity Exchange Act. These authorities were further enhanced as a result of the 2008 Farm Bill. As such, the CFTC has been aggressively utilizing existing authorities to oversee the futures and options markets.

First, the CFTC's Division of Enforcement has been actively policing the markets for fraud, manipulation and other unlawful conduct. In the last fiscal year, the agency has filed 50 enforcement actions, constituting a 25 percent increase in filings over the prior year. Commission enforcement actions resulted in more than \$280 million in civil monetary penalties, restitution and disgorgement from respondents and defendants in CFTC enforcement actions. Notably, 15 of the 50 cases involved fraud in connection with pooled investments, and 16 involved fraud against retail foreign currency customers.

The CFTC works closely with other federal, state criminal and civil enforcement authorities. During fiscal year 2009, nearly 90 percent of the CFTC's civil injunctive fraud cases involved related criminal investigations and, to date, more than 45 percent of those investigations have resulted in criminal indictment. Over the same time, more than 60 percent of the CFTC's civil injunctive fraud cases involved cooperative investigations with SEC staff.

Second, the CFTC implemented new transparency efforts to give more accurate depictions of the makeup of the futures markets to the public. For the first time, we are providing the market with information about swap dealers and managed accounts on a weekly basis, as well as breaking out index investors on a regular basis. For decades, the CFTC has provided the public with weekly Commitments of Traders (COT) reports consisting of aggregated large-trader position data to shed light on the changing composition of the markets.

On September 4, 2009, the Commission began disaggregating its weekly COT reports to make the categories of traders more specific and accurate. Prior to September, the COT reports broke traders into two broad categories: commercial and noncommercial. The new disaggregated reports improved upon the previous reports by breaking the data into four categories of traders: Producer/Merchant/Processor/User; Swap Dealers; Managed Money; and Other Reportables. The CFTC is releasing disaggregated data for contracts based on physical commodities and is reviewing how to best move forward on contracts for financial futures.

In addition to disaggregating the CFTC's COT reports, the agency began periodically releasing data on index investment in the commodity futures markets. In September 2008, the

CFTC published a Report on Swap Dealers and Index Traders that was based on data received from our special call authority. The CFTC continued this special call and enhanced the information disseminated in the original report. On September 4, the agency began releasing the data on a quarterly basis. The new data includes both gross long and gross short positions and updates data in the previously released report to include some additional data. The Commission will soon begin releasing this data on a monthly basis.

Third, the CFTC has proposed rules to set position limits in the four major energy futures contracts. The Commission held three hearings in late July and early August to hear from the public on whether position limits would benefit the markets. In January, the Commission held a public meeting to hear a staff recommendation to set position limits in the crude oil, natural gas, heating oil and gasoline futures markets. Interested persons may submit comments on the proposed rule to the Commission until April 26, 2010.

In addition to setting position limits in the energy markets, the proposed rulemaking would adjust how exemptions from the limits are granted. The proposed rulemaking both addresses exemptions for bona fide hedgers and establishes a consistent framework for certain swap dealer risk management exemptions. The Commission and the exchanges currently grant relief from agriculture and energy position limits to swap dealers on a case-by-case basis via staff no-action letters or similar methods at the exchanges. The proposed rule would bring uniformity to swap dealer exemptions, requiring swap dealers to file an exemption application meeting specific requirements and to update the application annually. Exempted swap dealers also would be required to provide monthly reports of their actual risk management needs and

maintain records that demonstrate their net risk management needs. The CFTC would publicly disclose the names of swap dealers that have filed for an exemption after a six-month delay. The proposed changes to the exemptions process builds upon earlier work of the Commission, when, under Acting Chairman Dunn, it issued a concept release on risk management exemptions. In the proposed rulemaking, the CFTC also is soliciting comments on the new exemption framework and whether it should be applied to the agriculture markets.

Further, the CFTC has announced that the agency will hold another meeting on March 25 and invite members of the public to testify on the broad issues related to the CFTC's regulation of the metals futures markets and whether position limits should be set in these markets.

Fourth, the CFTC is fulfilling its statutory obligations under the 2008 Farm Bill to regulate certain derivatives, including energy derivatives, traded on ECMs. If a contract that is traded on one of these facilities is found to perform a significant price discovery function, the contract and the facility are subject to heightened regulation and required to comply with key core principles that also apply to the trading of futures contracts.

The Commission has so far determined that the ICE Henry Financial LD1 Fixed Price Contract traded on the ICE – the largest volume natural gas swap contract traded on an ECM – serves a significant price discovery function, and thus is subject to heightened regulation. ICE is now regulated for this contract in accordance with all of the core principles laid out in the Farm Bill. Following the statutory obligations of the 2008 Farm Bill, the CFTC is analyzing - and has

sought public comment on - an additional 42 energy contracts, including natural gas and electricity contracts, to determine whether they meet the criteria to be regulated as SPDCs.

Fifth, as directed by the 2008 Farm Bill, the CFTC in January proposed regulations concerning off-exchange retail foreign currency transactions. Pursuant to this authority, the Commission released for public comment a comprehensive scheme that would put in place requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital and other operational standards. Specifically, the proposed regulations would require the registration of counterparties offering retail foreign currency contracts as either futures commission merchants (FCMs) or retail foreign exchange dealers (RFEDs), a new category of registrant created by the Farm Bill. Persons who solicit orders, exercise discretionary trading authority and operate pools with respect to retail forex would also be required to register, either as introducing brokers, commodity trading advisors, commodity pool operators or as associated persons of such entities.

The proposed regulations also include financial requirements designed to ensure the financial integrity of firms engaging in retail forex transactions and robust customer protections. All retail forex counterparties and intermediaries under CFTC jurisdiction would be required to distribute forex-specific risk disclosure statements to customers, and comply with comprehensive recordkeeping and reporting requirements. So far, the Commission has received more than 5,600 public comment submissions related to the forex proposal.

Further, enactment of the Farm bill enhanced the CFTC's enforcement authority over retail foreign currency. Since enactment of the bill in June 2008, the CFTC's Division of Enforcement has filed 19 fraud actions involving foreign currency transactions.

Sixth, the Commission has enhanced its market surveillance capabilities by requesting more information from foreign markets that provide direct access to American traders. Last year, the agency strengthened the conditions under which ICE Futures Europe can list for trading cash-settled contracts that settle based upon the prices of contracts traded on the New York Mercantile Exchange (NYMEX). The new conditions include requirements to provide Commission staff with trade execution and audit trail data and access to ICE staff for on-site visits to oversee compliance with the terms imposed by the CFTC. These conditions build upon the prior cooperative arrangements between the Commission and the United Kingdom's Financial Services Agency to address cross-border oversight of the U.S. and U.K. energy markets, including most notably the reporting of large trader positions in linked energy contracts.

Seventh, the Commission has been very concerned about the lack of convergence in the Chicago Board of Trade (CBOT) Soft Red Winter Wheat contract over the past couple years. From July to December of 2008, the futures price was between \$1.15 and \$2.00 over the Toledo cash price. By late last year, the basis had narrowed to \$0.67 per bushel and is currently approximately \$0.52.

Last October, Commissioner Dunn convened a meeting of the Agriculture Advisory Committee to discuss the convergence problem. The CBOT also was conducting its own

reviews. From those reviews, the CBOT decided to implement a variable storage rate proposal that will take effect in July. The Commission will continue to monitor the effectiveness of variable storage rates to see if they address the convergence problem. If convergence does not improve, the Commission will consider whether additional measures are necessary.

Further, in August, to ensure that position limits were consistently applied, Commission staff revoked two no-action letters that permitted two firms using certain index-based trading strategies to exceed position limits in the wheat futures markets.

Eighth, the CFTC is working with the Securities and Exchange Commission (SEC) on an ongoing project to harmonize regulations. In October, the agencies released a joint report that contains 20 recommendations, including proposals for statutory and regulatory changes to improve protections for the American public. Eleven of the recommendations relating to the CFTC require legislation.

The House included some of our recommendations in its recently-passed financial regulatory reform package. The bill would establish similar firewalls for commodity and futures dealers that currently exist for securities dealers. Securities regulations require the establishment of firewalls between the research, investment banking and trading arms of broker-dealers. Without parallel protection in the futures markets, trading desks could use information developed by research arms before that information is shared with the firm's clients, raising serious questions about the integrity of the firm's services to its clients and confidence in the markets. The House bill also includes language authorizing the CFTC to police the markets for disruptive

trading practices and to ensure that the CFTC has the ability to enact regulations that it determines are necessary to implement the requirements of the Commodity Exchange Act.

When the House passed its financial regulatory reform bill, however, staff had not yet finished drafting legislative language for some of the changes recommended in the harmonization report. As such, we will provide language to the Senate as they consider financial regulatory reform legislation. Chief among these recommendations are reforms to fiduciary standards for investment advisors and prohibitions on using misappropriated government information to trade in the futures markets.

- Any person that offers investment advice to customers should be governed by the same fiduciary standard, regardless of whether the underlying financial instrument is regulated by the SEC or the CFTC. Currently, broker-dealers, investment advisors and commodity trading advisors are all subject to different standards, depending on the particular financial instrument that is offered, even though they perform the same function – to deliver investment advice. We have recommended that there be a uniform standard that financial advice should be solely in the interest of the customer, without regard to the advisor’s own financial interests.
- We have recommended banning using misappropriated government information to trade in the commodity markets. In the movie “Trading Places,” starring Eddie Murphy, the Duke brothers intended to profit from trades in frozen concentrated orange juice futures contracts using an illicitly obtained and not yet public Department of Agriculture orange

crop report. Characters played by Eddie Murphy and Dan Aykroyd intercept the misappropriated report and trade on it to profit and ruin the Duke brothers. In real life, using such misappropriated government information actually is not illegal under our statute. To protect our markets, we have recommended what we call the “Eddie Murphy” rule to ban insider trading using nonpublic information misappropriated from a government source.

Over-the-Counter Derivatives Reform

In addition to implementing the authorities established in the Commodity Exchange Act, the CFTC also is working with Congress to bring comprehensive regulation to the over-the-counter derivatives marketplace.

Specifically, regulatory reform should, among other things:

- Require that swap dealers and major swap participants register and come under comprehensive regulation, including capital standards, margin requirements, business conduct standards and recordkeeping and reporting requirements;
- Require the use of transparent, regulated trading facilities for standardized swaps;
- Ensure that clearable swaps are submitted to and settled through central clearinghouses; and
- Provide the CFTC with authority to impose aggregate position limits across both futures and OTC derivatives markets.

Resources

Before I close, I will briefly address the CFTC's need for additional resources. Ten years ago, the CFTC was near its peak staffing level at 567 employees, but shrunk by more than 20 percent over the subsequent eight years before hitting a historic low of 437. Due to increased funding from Congress, the CFTC had more than 580 staff on board at the beginning of fiscal-year 2010, which is a significant improvement. Still, merely raising our staffing levels to the same as a decade ago will not be enough to adequately fulfill the agency's statutory mandate. In the last ten years, futures trading volume increased almost five-fold. The number of actively traded futures and options contracts increased seven-fold, and many of these have become considerably more complex in nature. We also moved from an environment with open-outcry pit trading to highly sophisticated electronic markets. What was once a group of regional domestic markets is now a global marketplace. What was once a \$500 billion business has grown to a \$33 trillion industry.

Despite rapid advances in technology and the increased size and number of regulated futures markets, funding for the agency has lagged behind the growth of the markets, and the CFTC has struggled to keep pace with the markets. While market participants have the technology to automate their trading, we've yet to have the resources to employ modern technology to automate our surveillance and oversight of compliance. Further, the CFTC does not have the staffing levels or the resources to conduct regular annual examinations of exchanges and clearinghouses. Instead, we can conduct those examinations only periodically and have no

choice but to leave routine examinations of intermediaries to self-regulatory organizations. The CFTC needs resources to conduct yearly examinations of the registrants we regulate.

For these reasons, it is appropriate for our staffing levels and our technology to be bolstered to meet the new financial realities of the day. As such, the CFTC's Budget and Performance Estimate for FY 2011, for existing statutory authorities, would increase the agency's funding by \$47.2 million to \$216 million and would augment agency staff by 95 FTE to a total of 745 FTE.

Additional funding would allow the CFTC to make much-needed improvements to our surveillance and technology programs. Further, it would allow the agency to increase staff levels to better keep up with the growing futures and options markets.

The President's budget proposes additional appropriations for the Commission contingent on the enactment of financial regulatory reform legislation. Commission staff estimated that with enactment of H.R. 4173, the Commission would require an additional 238 FTE to carry out its provisions. The budget recommends \$45 million, including \$27 million to provide for 119 additional FTE in FY 2011 and anticipates funding in FY 2012 for an additional 119 FTE.

Closing

In closing, I am pleased to report that the Commission has been actively utilizing existing authorities to oversee the regulated futures markets. We have managed an active agenda,

ranging from implementing provisions of the 2008 Farm Bill to improving existing regulatory schemes to working with Congress on new regulatory reforms. I look forward to continuing to work with this Subcommittee on important efforts to protect the American public.

I thank you for inviting me to testify today. I will be happy to answer any questions you may have.