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BEFORE THE
U.S. SENATE HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
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Good morning Chairman Levin, Ranking Member Coburn and members of the Subcommittee. I thank you for inviting me to today's hearing on position limits and the changing nature of the derivatives markets. I also thank my fellow Commissioners and CFTC staff for their hard work and commitment to implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act and the CFTC's existing futures market oversight.

Before I get to the CFTC's position limits rulemaking, I would like to first discuss how markets have changed over time and update the Subcommittee on the CFTC's work to ensure our 21st century markets have 21st century regulations.

Changing Nature of the Derivatives Markets

The derivatives markets have changed significantly since the CFTC opened its doors in 1975.

A new unregulated derivatives market – the swaps market – developed in the 1980s. The swaps market has grown in size and complexity to the point where it now is more than seven times the size of the futures market.

The futures market has changed dramatically as well.

First, there has been a significant increase in electronic trading. Instead of being traded in trading pits, more than 80 percent of futures and options on futures were traded electronically in 2010.

Second, the makeup of the market has changed. In contrast with the early days of the CFTC, swap dealers now comprise a significant portion of the markets. Also, many investors today treat commodities as an asset class for investment. Based on published CFTC data, financial actors, such as swap dealers, managed money accounts and other non-commercial reportable traders, make up a significant majority of many futures markets.

For example, based upon CFTC data as of October 25, 2011, only about 12 percent of long positions and about 18 percent of short positions in the WTI crude oil market were held by producers, merchants, processors and users of the commodity. Similarly, only about 13 percent of gross long positions and about 31 percent of gross short positions in the Chicago Board of Trade wheat market were held by producers, merchants, processors and users of the commodity.

Third, CFTC data shows the vast majority of trading volume in key futures markets – more than 80 percent in many contracts – is day trading or trading in calendar spreads. Only a modest proportion of average daily trading volume results in reportable traders changing their net long or net short futures positions for the day. This means that about 20 percent or less of the trading is done by traders who bring a longer-term perspective to the market on the price of the commodity. This summer we published on our website historical data on net position changes to enhance market transparency. The data reflects trading that changes or creates an end-of-day position, as contrasted with trading that does not change a trader's end-of-day net position, such as spread or day trading.

Ensuring that Regulations Keep up with the Markets

The CFTC is focused on ensuring our regulations are responsive to today's markets. We are implementing the historic Dodd-Frank Wall Street Reform and Consumer Protection Act, which gives the Commission oversight of the nearly \$300 trillion swaps market. Dodd-Frank includes many important provisions, but includes two overarching goals of reform: bringing transparency to the swaps market and lowering the risks of this market to the overall economy. Both of these reforms will better protect taxpayers from again bearing the brunt of a financial crisis and will cut costs for businesses and their customers.

As the Commission considers Dodd-Frank rules, we have benefited from significant public input throughout the process. We have received more than 25,000 comment letters.

CFTC staff and Commissioners have met more than 1,000 times with members of the public to discuss the rules. We have conducted 14 public roundtables on Dodd-Frank.

This summer, the agency turned the corner and began finalizing rules to make the swaps marketplace more open and transparent for participants and safer for taxpayers. We have held 20 public meetings where we finalized 18 rules, and we have more public meetings scheduled this year and into next year.

While each rule is important for the public's protection, I will highlight a few important measures for you.

We approved a final rule to implement enhanced anti-manipulation and anti-fraud authority. These tools are similar to rules that the Securities and Exchange Commission, Federal Energy Regulatory Commission and Federal Trade Commission have for securities and certain energy commodities. The new authority expands the CFTC's arsenal of enforcement tools and strengthens its ability to effectively deal with threats to market integrity.

In addition, the CFTC on July 7 approved a final rule on large trader reporting for physical commodity swaps. Prior to the Dodd-Frank Act, the Commission only had limited authority to obtain large trader data regarding the swaps market. The rule requires position reports on economically equivalent swaps from clearing organizations, their members and swap dealers.

Pre-Trade Risk Filters and Controls

As electronic trading has grown, we have seen a significant rise in high-frequency trading, and the CFTC is working to ensure our regulations are a match for modern challenges.

The Dodd-Frank Act requires that regulated trading facilities have the capacity and responsibility to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures. This includes methods for conducting real-time monitoring of trading, and comprehensive and accurate trade reconstructions.

In December 2010, the CFTC proposed a rule that would require that risk controls include market restrictions that pause or halt trading under specified market conditions and that trading facilities coordinate their risk controls. The proposed rule contemplates that other appropriate risk controls, such as price collars or bands, maximum order size limits, stop loss order protections, kill buttons and others, may also be required.

The CFTC also has proposed regulations to require each swap dealer, major swap participant and futures commission merchant that is a clearing member to establish credit and market risk-based limits based on position size, order size, margin requirements and other similar factors. The proposed regulations would require use of automated means to screen orders for compliance with the risk-based limits.

In addition, the proposed regulations would require monitoring for adherence to the risk-based limits intra-day and overnight. A clearing member could monitor and mitigate risk with the ability to see all working and filled orders for intraday risk management, or with a “kill button” that cancels all open orders for an account and disconnects electronic access.

Testing and Supervision

CFTC staff also is working on a release concerning a principles-based testing and supervision regime designed to ensure that electronic trading systems are tested and supervised by trained personnel and that appropriate risk controls are in place. If approved by the Commission, the release would seek comment concerning proposals designed to ensure that those who provide market access to customers establish, implement and enforce rules and procedures to mitigate some of the risks of high-frequency trading.

Increased Transparency

The CFTC is using existing authorities to increase transparency in the derivatives markets. When markets are open and transparent, they are safer and sounder, and costs will be lower for companies and the people who buy their products.

In September 2009, the Commission began disaggregating its weekly Commitments of Traders (COT) reports to make the categories of traders more informative. Before then, 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 for physical commodities into four categories of traders: Producer/Merchant/Processor/User; Swap Dealers; Managed Money; and Other Reportables. The CFTC also released five years of historical data so that regulators and the public could identify trends in the makeup of the markets. This data informs the market about swap dealer and managed money positions on a weekly basis.

Also, 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 pursuant to special call authority. Updated data is now released on a monthly basis and includes both gross long and gross short positions.

Position Limits

At our most recent public meeting, the CFTC finalized its rule to establish position limits for futures, options and swaps on 28 physical commodities as required by the Dodd-Frank Act. Before I discuss the specifics of the rulemaking, I will provide the historical and regulatory contexts for position limits.

Legislative and Regulatory History of Position Limits

Since 1936, the Commodity Exchange Act has prescribed position limits to protect against the burdens of excessive speculation, including those caused by large concentrated positions. Between the CFTC and the futures exchanges, there are currently position limits in

the spot month on physical delivery contracts in the agricultural, energy and metals markets. There also are a number of agricultural contracts that have single-month and all-months-combined position limits that apply to contracts beyond the spot month. The exchanges had set all-months-combined limits in energy markets until 2001 and in metals markets earlier; however, those limits were replaced with position accountability regimes.

When the CFTC set position limits in the past, the agency sought to ensure that the markets were made up of a broad group of participants with a diversity of views. At the core of our obligations is promoting market integrity, which the agency has historically interpreted to include ensuring that markets do not become too concentrated.

Position Limits Rulemaking

Position limits are a critical tool to ensure that a single trader does not accumulate an outsize position that could potentially affect integrity or liquidity in the marketplace. Position limits help protect markets both in times of clear skies and when there is a storm on the horizon. In 1981, the Commission said that “the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited.”

Though the CFTC does not set or regulate prices, volatile prices for basic commodities highlight the importance of effective market oversight that ensures integrity and transparency.

Public Hearings on Speculation and the 2010 Position Limits Rulemaking

In July and August 2009, the CFTC held three public meetings to gather input from the public and Members of Congress regarding position limits for energy markets. In January 2010, the Commission published a proposed rule to reestablish position limits on four energy contracts. In response to the proposal, the CFTC received more than 8,200 comments from the public. In March 2010, the Commission held an additional public meeting to consider the appropriateness of position limits in the metals markets.

Following the passage of the Dodd-Frank Act, the CFTC withdrew that proposal in August 2010 with plans to re-propose pursuant to the new law's specific requirements. To be properly informed during the Dodd-Frank position limits rule-writing process, the Commission and its staff reviewed the comments received in response to the January 2010 rulemaking as well as those received in response to the public meeting regarding metals markets.

Final Rulemaking to Set Position Limits

In the Dodd-Frank Act, Congress broadened the CFTC's position limits authority to include aggregate position limits on certain swaps and certain linked contracts traded on foreign boards of trade, in addition to U.S. futures and options on futures. Congress also narrowed the exemptions from position limits by modifying the definition of a bona fide hedging transaction in physical commodities.

After reviewing more than 15,100 public comments, the CFTC finalized a position limits rule on October 18 implementing the important new Dodd-Frank authorities to prevent excessive speculation and manipulation in the derivatives markets. The rule is designed to ensure sufficient market liquidity for bona fide hedgers as well as to protect price discovery from disruption. The final rule establishes position limits for 28 physical commodity futures and options contracts and physical commodity swaps that are economically equivalent. It applies on an aggregate basis across different trading venues, including certain foreign exchanges, to contracts based on the same underlying commodity.

The final rulemaking includes one position limits regime for the spot month and another regime for single-month and all-months combined limits. It will implement spot-month limits, which are currently set in agriculture, energy and metals markets, sooner than the single-month or all-months-combined limits.

Spot-month and non-spot month legacy limits will be implemented 60 days after the CFTC, jointly with the SEC, further defines the term “swap.” Under the final rule, these limits will be implemented on an advanced schedule because they are based on current exchange spot-month limits and would be adjusted on a regular schedule, based on 25 percent of the underlying deliverable supply.

Single-month and all-months-combined limits, which the Commission currently only sets for certain agricultural contracts, will be re-established in the energy and metals markets and extended to certain swaps. The Commission will set the limits following the collection of

sufficient swaps positional data gathered under the CFTC's recently adopted swaps large trader reporting rule.

Consistent with the Dodd-Frank definition of "bona fide hedging," the final rulemaking provides that, to qualify, a transaction or position must serve to mitigate a risk in the cash market for a physical commodity. To provide clarity, the Commission's proposed rule provides a list of examples that may be classified as bona fide hedges.

The final rulemaking establishes an enhanced reporting regime for traders who, in certain energy and metals contracts, hold positions that are below the position limits but above a specified number of net long or net short contracts. Once a trader crosses a position visibility level, the trader will be required to file quarterly reports to the CFTC that generally capture the trader's physical and derivatives portfolio in the commodity. These reports will enhance the Commission's surveillance abilities and increase transparency in the marketplace.

International Coordination

In addition to working on the position limits rule at home, we also have been actively coordinating with international regulators. In September, the International Organization of Securities Commissions (IOSCO) adopted a commodity markets report that embraces a position management regime. The report also includes recommendations for more transparency on the international side, similar to our COT reports, and a stronger anti-manipulation regime that adds authorities to police against attempted manipulation.

Resources

With the passage of the Dodd-Frank Act, the CFTC is taking on a significantly expanded scope and mission. As we continue to finalize rules, market participants will increasingly seek guidance from the CFTC. But only with sufficient funding will we be able to be as responsive to the public as we should be.

The agency must be adequately resourced to assure the nation that new market rules will be strictly enforced – rules that promote transparent markets, lower costs for consumers and protect taxpayers. We need sufficient resources to put enough cops on the beat for the public's protection.

Closing

Thank you, and I'd be happy to take questions.