TESTIMONY OF

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FORMER CHAIRPERSON, COMMODITY FUTURES TRADING COMMISSION

CONCERNING THE OVER-THE-COUNTER DERIVATIVES MARKET

BEFORE THE JOINT ECONOMIC COMMITTEE OF CONGRESS

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Madam Chair and Members of the Committee:

Thank you for inviting me to appear before you to discuss the over-the-counter derivatives market.

When I was Chairperson of the Commodity Futures Trading Commission more than a decade ago, I spoke out about the dangers posed by the rapidly growing and unregulated over-the-counter derivatives market and called for effective federal oversight. I was aware that powerful interests in the financial community were opposed to any examination of that market. Yet I spoke out because, as the head of the federal regulatory agency with the greatest experience and expertise in derivatives markets, I felt a duty to let the public, Congress and the other financial regulators know the potential threats to our financial stability. I strongly believed that the lack of transparency and the absence of government oversight of over-the-counter derivatives had to be remedied by the adoption of appropriate regulation.

My voice was not popular. The financial markets had been expanding, innovation was thriving, and the country was prosperous. The financial services industry argued that markets had proven themselves to be self-regulating and that the role of government in market oversight and regulation should be reduced or eliminated.

All of us have now paid a large price for that fallacious argument. We have experienced the most significant financial crisis since the Great Depression, and regulatory gaps, including the failure to regulate over-the-counter derivatives, have played an important role in the crisis. We have now spent hundreds of billions of taxpayer dollars to deal with the financial crisis, and the American people have experienced massive losses of jobs, homes, savings and businesses.

As a result of pressures from a number of the country's largest financial institutions, Congress passed a statute in 2000 that eliminated virtually all government regulation of the over-the-counter derivatives market, the Commodity Futures Modernization Act of 2000. Because of that statute, no federal or state regulator currently has oversight responsibilities or regulatory powers over this market.

The market is totally opaque and is often referred to as "the dark market." It is enormous. At its height a year and a half ago in June 2008 the reported size of the market exceeded $680 trillion in notional value or more than ten times the gross domestic product of all the countries in the world. As of June 2009 the market reportedly still exceeded $600 trillion in notional value.

While over-the-counter derivatives have been justified as vehicles to manage financial risk, they have in practice spread and multiplied risk throughout the economy and caused great financial harm. Lack of transparency and price discovery, excessive leverage, rampant speculation, lack of adequate capital and prudential controls, and a web of interconnections among counterparties have made the market extremely dangerous. Warren Buffet has appropriately dubbed over-the-counter derivatives "financial weapons of mass destruction." They include the credit default swaps disastrously sold by AIG and many of the toxic assets held by our biggest banks. They spurred the housing and credit bubbles and accelerated the contagion as the bubbles burst and the crisis spread. A number of the financial firms that failed or have required extraordinary government support during the recent crisis were among the world's major over-the-counter derivatives dealers, including AIG, Bear Stearns, Lehman Bros., CitiGroup, Merrill Lynch, Bank of America, Morgan Stanley, Goldman Sachs, and J.P. Morgan.

This over-the-counter market continues to be unregulated and to pose grave dangers to the economy. It is critically important for Congress to act swiftly to impose the rules necessary to close this regulatory gap and to protect the public. As time passes and the economy appears to be stabilizing, there is a danger that the sense of urgency to adopt these important reforms may diminish. We now have a unique opportunity -- a narrow window of time -- to fashion and implement a comprehensive regulatory scheme for these instruments.

Existing U.S. laws governing the futures and options markets provide a worthy model for regulating the closely related instruments traded in the over-the-counter derivatives market. The Commodity Futures Trading Commission and the Securities and Exchange Commission should have primary regulatory responsibilities for derivatives trading, both on and off exchange. As with futures and options, all standardized and standardizable derivatives contracts should be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations. A regulatory regime based on the requirements established in the Commodity Exchange Act for designated contract markets and derivatives clearing operations should apply to such trading and clearing. These requirements would allow effective government oversight and enforcement efforts; ensure price discovery, openness and transparency; reduce leverage and speculation; and limit counterparty risk. While central clearing would mitigate counterparty risk, central clearing alone is not enough. Exchange trading is also essential in order to provide price discovery, transparency and meaningful regulatory oversight of trading and intermediaries.

In my view, there should be no statutory exceptions from the rule that all standardized and standardizable contracts should be traded on exchange rather than over-the-counter. Some large corporations are arguing that they should be permitted to continue to trade standardized contracts over-the-counter because they wish to avoid paying the cash margins required for exchange-traded contracts. Such an exception is unwarranted. Large corporations will benefit from the price discovery, transparency and regulatory oversight of exchange trading, which generally should lead to lower prices for trades. Moreover, creditworthy corporations should be able to obtain lines of credit as needed to meet their margin requirements for exchange trading.

The over-the-counter market is necessarily much less transparent and much more difficult to regulate than an exchange market. If any trading in over-the-counter derivatives is permitted to continue, such trading should be limited to truly customized, non-fungible contracts between highly sophisticated parties at least one of which requires such a customized contract in order to hedge actual business risk. Such customized contracts by their nature cannot be traded on an exchange or cleared by a clearing house. While customized over-the-counter contracts may serve an economically useful purpose by allowing businesses to hedge complex business risks, there is no adequate justification for allowing purely speculative customized contracts to be traded in the more dangerous over-the-counter market. Therefore, at least one party to every over-the-counter contract should be required to certify and be able to demonstrate that it is using a customized contract to hedge a bona fide business risk. So limiting the over-the-counter market would reduce the potential risks created by that market.

Furthermore, any continuing over-the-counter market should be subject to a robust federal regulatory regime requiring transparency and protections against abuses and catastrophic defaults. There should be registration, recordkeeping and reporting requirements for all over-the-counter derivatives dealers, and they should be subject to business conduct standards, including requirements to disclose contract terms, pricing and risks to their customers. All over-the-counter trades should be subject to margin requirements, and all large market participants should be subject to capital requirements. In addition, transaction prices and volumes of over-the-counter derivatives should be publically reported on an aggregated and timely basis. The market should be subject to prohibitions against fraud, manipulation and other abusive practices.

These measures would go far toward bringing this enormous and dangerous market under control. They should be adopted and implemented if we hope to avoid future financial crises caused by this market. The country cannot afford to delay or weaken our response to the crisis. If we as a people do not learn from our experiences and respond appropriately, we will be doomed to repeat them.

Thank you very much.