Testimony of Chairman Timothy G. Massad before the
U.S. Senate Committee on Agriculture, Nutrition & Forestry
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Thank you, Chairman Roberts, Ranking Member Stabenow, and members of the Committee. I appreciate the opportunity to testify before you today regarding the work of the Commodity Futures Trading Commission (CFTC), and am pleased to be here on behalf of the Commission.

I want to thank you for the opportunities I have had to meet with many of you and for your input on the issues facing the Commission. I look forward to continuing to work with the Committee.

The CFTC oversees the futures, options, and swaps markets. While most Americans do not participate directly in these markets, they are very important to the daily lives of all Americans, because they shape the prices we all pay for food, energy, and many other goods and services. They enable farmers to lock in a price for their crops, utilities to manage their fuel cost, and manufacturers to hedge the price of industrial metals. They enable exporters to hedge foreign exchange risk and businesses of all types to lock in borrowing costs. In short, the derivatives markets enable businesses of all types to manage risk.

For these markets to work well, sensible regulation is essential.

That is why the Commission's job is so important. We must do all we can to prevent fraud and manipulation in these markets, and create a regulatory framework that promotes efficiency, competition, and innovation so that these markets can continue to serve the businesses that depend on them.

The futures and options markets that we oversee have grown enormously in size, sophistication, and technological complexity. In fact, the number of actively traded futures and options contracts has doubled since 2010 and increased six times over the last 10 years. The Commission is responsible for overseeing the markets in over 40 physical commodities, as well as a wide range of financial futures and options products based on interest rates, equities, and currencies. There are over 4,000 actively traded futures and options contracts and thousands more subject to our oversight when all tenors and associated options are included. The days when market surveillance could be conducted by observing traders in floor pits are long gone. Today, not only is almost all trading electronic, but in many products a majority is conducted through highly sophisticated automated trading programs. On a typical day, there may be 750,000 transactions in Treasury futures and more than 700,000 in just the E-mini S&P 500 contract, the most active equity index future. In just a single commodity category such as crude oil, there are typically hundreds of thousands of transactions every day. Transactions are only part of the picture, however. In today's high speed markets, manipulation and fraud are often conducted using complex strategies involving bids and offers, which far outnumber consummated transactions. Each day in the Treasury futures market, for example, there can be millions of bids and offers**.**

In addition to the challenges posed by the growth and increasing complexity of the futures and options market, our responsibilities now include overseeing the swaps market, an over $400 trillion market in the U.S., measured by notional amount. This market continues to change rapidly, and overseeing it presents unique challenges. For example, because there are multiple trading platforms, data must be analyzed across platforms. There is also considerable voice-driven activity and complexities to the execution and processing of trades that do not exist in the vertically integrated futures markets and that require different surveillance mechanisms. Aggregating data to understand participants' positions across futures and swaps markets is particularly challenging.

We all saw what happened in 2008 because we did not have reasonable oversight of the swaps market, when the build-up of excessive risk contributed to the worst financial crisis since the Great Depression. That crisis resulted in eight million Americans losing their jobs, millions of foreclosed homes, countless retirements and college educations deferred, and businesses shuttered. In thinking about the importance of the CFTC's work, it is noteworthy that the amount of taxpayer dollars that were spent just to prevent the collapse of AIG as a result of its excessive swap risk was over 700 times the size of the CFTC's current budget.

Since taking office almost one year ago, the Commission has been very busy. First, we have been fine-tuning our rules in a number of areas to address concerns of commercial end-users, because it is essential that, as we implement this new framework, commercial companies can continue to use the derivatives markets effectively to hedge commercial risk. A second priority has been to finish the few remaining rules mandated by Dodd-Frank, such as margin and position limits. We have also been working to improve the regulatory framework in other areas such as trading of swaps. In addition, we are also focused on harmonizing rules with other regulators – domestic and international – as much as possible. We are working hard on improving and standardizing the data collection and analysis efforts as well. We remain committed to a robust enforcement and compliance program to prevent fraud and manipulation. And we have been addressing new developments and challenges in our markets, particularly those created by technological development, such as cybersecurity concerns.

Today, I would like to highlight some of what we have accomplished as well as some key priorities going forward.

I know I speak for all the Commissioners in first thanking our staff for their hard work and dedication. The progress we have made is a credit to their commitment and their tireless efforts.

I also want to thank each of my fellow Commissioners. I commend them in particular for their efforts to reach out and make sure we are all well informed by a diversity of views, and for their willingness to collaborate and work constructively together. While we will not always agree, I believe we are working together in good faith to do the best job we can in implementing the law and carrying out the Commission's responsibilities.

Over the last several months, the Commission has been actively listening to market participants, getting important feedback on what is working well and what parts of our regulatory framework may need adjusting. We have held two open meetings as well as several staff roundtables, and

we will hold more in the future. The CFTC's advisory committees have also provided a good venue for dialogue.

Last December, we had a productive meeting of our Agricultural Advisory Committee, of which I am the sponsor. We were honored to have Secretary Vilsack as our special guest. It was an excellent opportunity to gather input directly from farmers, ranchers, and others who rely on these markets day in and day out. Later today, Commissioner Wetjen will be holding a meeting of our Global Markets Advisory Committee (GMAC), to discuss clearinghouse stress testing and margin for uncleared swaps. This follows up on a very informative session last October on clearing of non-deliverable forward contracts and the digital currency bitcoin. He will also soon be convening a meeting of our Technology Advisory Committee, which advises on the impact and implications of technological innovations in our markets. Commissioner Bowen held a very productive meeting of our new Market Risk Advisory Committee last month, which focused on clearinghouse risks and other issues. Another meeting is scheduled for June 2. And Commissioner Giancarlo has been leading our Energy and Environmental Markets Advisory Committee, which met in February to discuss position limits and related topics.

Each of us also spends time meeting with market participants individually. All of us are very committed to making sure we are listening to market participants and their concerns.

Let me turn now to the progress we have made in each of the general areas I noted.

Making Sure the Markets Work for Commercial End-Users

For the derivative markets to contribute to the broader economy, they must work well for commercial end-users – the many manufacturers, farmers, ranchers, and other businesses that rely on these markets to hedge commercial risks. Over the last 11 months, we have made it a priority to address concerns of these participants. We have sought to make sure that our rules do not impose undue burdens or create unintended consequences for these participants. We have taken several actions to make sure that commercial end-users can continue to use the derivatives markets effectively and efficiently. Some of the steps we have taken include:

- Margin for Uncleared Swaps. We have made sure that our proposed rule on margin for uncleared swaps exempts commercial end-users from this requirement. We have also worked with the domestic bank regulators, who are also responsible for issuing rules on this subject, to maintain a comparable approach for commercial end-users.

- Public Utility Companies. In September, the Commission amended its rules so that publicly-owned utility companies could continue to effectively hedge their risks in the energy swaps market. These companies, which keep the lights on in many homes across the country, must access these markets efficiently in order to provide reliable, cost-effective service to their customers. The Commission unanimously approved a change to the swap dealer registration threshold for transactions with special entities which will make that possible.

- Customer Protection/Margin Collection. In March, the Commission unanimously approved a final rule to modify one aspect of our customer-protection related rules, which had previously been unanimously adopted in the wake of MF Global's insolvency and were designed to prevent a similar failure from recurring and to protect customers in the event of such a failure. To address a concern of many in the agricultural community and many smaller customers regarding the posting of collateral for their trades, we removed a provision that would have automatically changed the deadline for futures commission merchants (FCMs) to post "residual interest," which, in turn, can affect when customers must post collateral.

- Recordkeeping Requirements. We have proposed to exempt end-users and commodity trading advisors from certain recordkeeping requirements related to text messages and phone calls. This proposal is designed to make sure we do not impose undue burdens on commercial end-users.

- Treasury Affiliates of End-Users. The Commission staff took action to make sure that end-users can use the statutory exemption given to them regarding clearing if they enter into swaps through a treasury affiliate. It is common for a large corporation with significant non-financial operations to have an affiliate enter into swaps and financing transactions on behalf of the larger corporation and its subsidiaries. In addition, CFTC staff recently provided interpretive guidance on how Special Purpose Vehicles can qualify for the relief.

- Reporting Requirements for Contracts in Illiquid Markets. CFTC staff recently granted relief from the real-time reporting requirements for certain less liquid, long-dated swap contracts that are not subject to mandatory clearing and do not yet trade on a regulated platform. We agreed to permit slightly delayed reporting for these swaps so that the real-time reporting requirements in Dodd-Frank do not lead to identifying market participants, as that could result in competitive harm.

- Aluminum Market. Another issue of concern to end-users that we are focused on pertains to the long queues for delivery of aluminum at warehouses in this country licensed by the London Metal Exchange (LME), and the relationship of those queues to the pricing and delivery of aluminum. While we do not have direct regulatory authority over those warehouses, and the LME's principal regulator is the Financial Conduct Authority (FCA) in the UK, we are looking at these issues closely and speaking with aluminum users, the LME, the HKEx Group, which owns the LME, and the FCA on a regular basis about actions they have taken and could in the future take to address these issues.

- Harmonization with SEC Rules. We continue to work closely with our colleagues at the SEC. For example, in connection with the SEC's efforts to implement the Jumpstart Our Business Startups Act ("JOBS Act"), we took action to harmonize our rules with the new requirements. Specifically, we revised requirements applicable to commodity pool operators that are also registered with the SEC.

- Volumetric Optionality. The Commission has recently approved a final interpretation regarding when certain agreements are forward contracts, rather than swaps. Specifically, we clarified when an agreement, contract, or transaction that contains embedded volumetric optionality falls within the forward exclusion from being considered a swap. "Embedded volumetric optionality" refers to the contractual right of a counterparty to receive more or less of a commodity at the negotiated contract price. Contracts with this feature are important to, and widely used by, a variety of end-users, including electric and natural gas utilities, and there had been concern and uncertainty created by the Commission's prior actions in this area. By clarifying how these agreements will be treated for regulatory purposes, the interpretation is intended to make sure commercial companies can continue to conduct their daily operations efficiently.

- Trade Options. Likewise, the Commission last month voted to issue a proposed rule reducing reporting and recordkeeping requirements with respect to trade options, which are a subset of commodity options. These products are also commonly used by commercial participants. Specifically, the proposal would reduce reporting and recordkeeping requirements for trade options, including by eliminating the requirement to file form TO. These products are commonly used by commercial participants, so this action should help those participants continue to do so cost-effectively.

In sum, we have been very focused on making sure these markets work for commercial end-users, and we will continue to do so.

Continuing Implementation of the New Regulatory Framework for Swaps

Let me turn now to our efforts to implement reforms to the swap market as part of the overall effort on financial regulatory reform. To address the regulatory gaps and build-up of excessive risk that caused the 2008 global financial crisis, and the role of over-the-counter (OTC) swaps, leaders of the G-20 nations agreed to reform the OTC swaps market. Title VII of the Dodd-Frank Act embodied the four basic commitments: require central clearing of standardized swaps through regulated clearinghouses; require regulatory oversight of the largest market participants; require regular reporting so that regulators and the public can have a view of what is happening in the market; and require transparent trading of swaps on regulated platforms.

We have made substantial progress in implementing these reforms. We are focused today on completing that work in a manner that ensures these markets continue to thrive and work well for all participants.

- Clearing of standardized swap transactions

A primary commitment of Dodd-Frank was to require clearing of standardized swaps transactions through clearinghouses. The use of clearinghouses in financial markets is commonplace and has been around for over one hundred years. The idea is simple: if many participants are trading standardized products on a regular basis, the tangled, hidden web created by thousands of private bilateral trades can be replaced with a more transparent and orderly

structure, like the hub and spokes of a wheel, with the clearinghouse at the center. The clearinghouse can then monitor the overall risk and positions of each participant.

In accordance with Congressional direction, the CFTC acted expeditiously to implement clearing mandates. The United States was among the first of the G-20 nations to do so. As directed by Congress, the CFTC specifically exempted from those mandates commercial end-users, including manufacturers or farmers who use the swaps markets to hedge. The CFTC also has exempted agricultural and electrical cooperatives, as well as banks with assets totaling less than $10 billion.

Currently, clearing through central counterparties is required in our markets for most interest rate and credit default swaps. Recent data show our progress. The percentage of transactions that are centrally cleared in the markets we oversee has gone from about 15% in December 2007 to about 75% today.

Of course, central clearing is not a panacea. Clearing does not eliminate the risk that a counterparty to a trade will default – instead it provides us with powerful tools to monitor that risk, manage it, and mitigate adverse effects should a default occur. For central clearing to work well, active, ongoing oversight of clearinghouses is critical. And given the increasingly important role of clearinghouses in the global financial system, this is a top priority.

Over the last few years, the agency has strengthened its clearinghouse regulatory framework, incorporating international standards and taking other steps to bolster risk management practices and customer protection. Today, we are engaged in extensive oversight activities that include, among other things, daily risk surveillance, stress testing, and in-depth compliance examinations. Our oversight efforts also focus on risk at the clearing member and large trader levels. And while our goal is to never get to a situation where recovery or resolution of a clearinghouse must be contemplated, we are currently working with fellow regulators, domestically and internationally, on the planning for such contingencies, in the event there is ever a problem that makes such actions necessary.

In addition, as detailed further below, we are addressing new risks like cybersecurity. This is a critical concern with respect to clearinghouses as well as other key infrastructure like exchanges.

- <u>Increased oversight of major market participants</u>

Since Congress passed Dodd-Frank, we have increased oversight of major market players through the registration and regulation of major swap participants and swap dealers. We have adopted rules requiring these registrants to observe strong risk management practices, and they will be subject to regular examinations to assess risk and compliance with rules designed to mitigate excessive risk.

The new framework requires registered swap dealers and major swap participants to comply with standard business practices, such as documentation and confirmation of transactions, as well as dispute resolution processes. They are also required to make sure their counterparties are eligible to enter into swaps, and to make appropriate disclosures to those counterparties about risks and conflicts of interest.

- Regular reporting for increased market transparency

Congress recognized that having rules that require oversight, clearing and transparent trading is not enough. We must have an accurate, ongoing picture of what is taking place in the market to achieve greater transparency and to address the potential risks. A key commitment in Dodd-Frank is ongoing reporting of swap activity. In 2008, regulators and Congress knew very little about the size and risks in this market. Today, under our rules, all swap transactions, whether cleared or uncleared, must be reported to registered swap data repositories (SDRs), a new type of entity responsible for collecting and maintaining this vital information.

This reporting will enable regulatory authorities to engage in meaningful oversight. Robust surveillance and enforcement, so critical to maintaining market integrity, depends on the availability of accurate market data. And increased transparency helps market participants by increasing competition, facilitating the price discovery process, and enhancing confidence in the integrity of the market. You can now go to public websites and see the price and volume for individual swap transactions. And the CFTC publishes the Weekly Swaps Report that gives the public a snapshot of the swaps market.

While we have made good progress, we have a considerable amount of work still to do to collect and use derivatives market data effectively. There are now four data repositories in the U.S. and more than 20 others internationally, plus thousands of participants who must report data.

We are focused on three general areas regarding data. First, we must have reporting rules and standards that are specific and clear, and that are harmonized as much as possible across jurisdictions, and we are leading an international effort in this regard. Only in this way will it be possible to track the market and be in a position to address emerging issues. We must also make sure the SDRs collect, maintain, and publicly disseminate data in a manner that supports effective market oversight and transparency. This means a common set of guidelines and coordination among registered SDRs. Standardizing the collection and analysis of swaps market data requires intensely collaborative and technical work by industry and the agency's staff. We have been actively meeting with the SDRs on these issues, getting input from other industry participants, and looking at areas where we may clarify our own rules.

As one example of rule clarifications, I expect that very soon we will initiate a rulemaking to clarify reporting of cleared swaps as well as the role played by clearinghouses in this workflow. This rulemaking will propose to eliminate the requirement to report Confirmation Data for intended to be cleared swaps that are accepted for clearing and thereby terminated. This will simplify reporting burdens and improve the data that we receive.

Finally, market participants must live up to their reporting obligations. Ultimately, they bear the responsibility to make sure that the data is accurate and reported promptly. We have already brought cases to enforce these rules and will continue to do so as needed.

- Transparent trading of swaps transactions on regulated platforms

With regard to swaps trading, there is also progress as well as work to be done. Congress mandated that certain swaps must be traded on a swap execution facility (SEF) or other regulated exchange. Transparent trading of swaps on these regulated platforms can facilitate a more open, transparent, and competitive marketplace, which will benefit all participants.

Trading on SEFs is still relatively new. The trading mandate for certain interest rate swaps and credit default swaps took effect in February 2014. We currently have almost two dozen swap execution facilities (SEFs). Each is required to operate in accordance with certain statutory core principles. These core principles provide a framework that includes obligations to establish and enforce rules, as well as policies and procedures that enable transparent and efficient trading. SEFs must make trading information publicly available, put into place system safeguards, and maintain financial, operational, and managerial resources necessary to discharge their responsibilities.

While SEF trading is relatively new, volumes are growing. In addition, the number of market participants using SEFs is increasing. One SEF recently confirmed that participation had exceeded 700 firms.

Our goal is to build a regulatory framework that not only meets the Congressional mandate of bringing this market out of the shadows, but which also creates the foundation for the market to thrive. To do so, the regulatory framework must ensure transparency, integrity and oversight, and, at the same time, permit innovation, freedom, and competition. To this end, we have been reviewing our rules and developing ways to improve them.

I want to note in particular the efforts of Commissioner Giancarlo. He has written a very thoughtful white paper about SEF trading. Chris's experience in the marketplace is of great value to us at the CFTC, and we are lucky to have him. Although I do not agree with his suggestion that we should throw out the rules and start over, we have already found common ground on a number of changes that will improve the framework, and I expect that we will continue to do so.

We have taken several steps recently to improve SEF trading. These have included the following:

- Package Transactions. Last fall, the staff issued no-action relief to provide market participants additional time to adapt to exchange-based trading. That phasing of compliance deadlines has worked well.

- Block Trades. The staff addressed the issue of pre-trade credit checks for block trades, and the so-called "occurs away" requirement, so that block transactions could continue to be negotiated between parties and executed on SEF.

- Error Trades. CFTC staff issued no-action relief that will streamline the process for correcting erroneous trades.

- Cleared Swap Reporting. As I noted above, we intend to revise our rules on the reporting of cleared swaps which will help improve trading by simplifying reporting obligations.

- SEF Confirmations. Staff has issued no-action relief permitting the SEF legal confirmation to incorporate the ISDA Master Agreement by reference. This also clarified and reduced the SEF reporting responsibility regarding uncleared swaps – SEFs need only report "Primary Economic Terms"– as well as any Confirmation Data they do in fact have.

- Flexibility Regarding Methods of Execution. Our staff has been working with SEFs to make it clear that our rules permit flexibility in methods of execution as long as the regulatory standards and goals are met. Staff has confirmed that an auction match trading protocol is acceptable as long as SEFs provide adequate transparency regarding the process for setting the offer price.

- SEF Financial Resources. Our staff has issued guidance that clarifies the calculation of projected operating expenses for the purpose of determining the capital that the law requires SEFs to hold. Specifically, the guidance clarifies that variable commissions that SEFs pay do not have to be included in a SEF's calculation of projected operating costs.

I would note that in some areas where the staff has acted by no-action letter to provide temporary relief at the request of industry participants, we are considering taking up the issue in a rulemaking in order to find a permanent solution.

We are looking at a number of additional issues concerning SEFs, such as the made available for trade determination process and concerns about the lack of post-trade anonymity for certain types of trades, and we will continue to do all we can to improve the regulatory framework and enhance SEF trading. In addition, as other jurisdictions develop their rules on trading, we will look to try to harmonize the rules as much as possible so as to minimize the risk of market fragmentation.

- Finalizing the Remaining Rules

We have also been working to finish the few remaining rules required for the new swaps regulatory framework as mandated by Congress, including the rule on margin for uncleared swaps. This rule plays a key role in the new regulatory framework because uncleared transactions will always be an important part of the market. Sometimes, commercial risks cannot be hedged sufficiently through swap contracts that are available for clearing. For example, certain products may lack sufficient liquidity to be centrally risk managed and cleared. This may be true even for products that have been in existence for some time. And there will and always should be innovation in the market, which will lead to new products. In these cases, margin will continue to be a significant tool to mitigate the risk of default from those transactions and, therefore, the potential risk to the financial system as a whole.

We proposed a revised rule last fall. Consistent with Congressional intent, our proposal exempts commercial end-users from the margin requirements applicable to swap dealers and major swap participants. Our approach seeks to provide a significant safeguard without imposing

unnecessary costs on participants whose activities do not create the same level of systemic risk. We will also make the minor changes necessary in our final rule to ensure conformity with the amendment to the Commodity Exchange Act (CEA) adopted by Congress in December as part of the Terrorism Risk Insurance Act (TRIA).

In formulating our approach, we coordinated closely with the relevant bank regulators, because Congress mandated that margin requirements be set by different regulatory agencies for the respective entities under their jurisdiction. Each swap dealer and major swap participant for which there is a prudential regulator must comply with margin rules established by that prudential regulator. All other swap dealers and major swap participants must comply with margin rules established by the CFTC. I am pleased to say that our rules and those of the bank regulators are substantially similar, and I am hopeful that we can finalize these rules by the summer.

We have also been working with our international counterparts in Europe and Japan to harmonize our proposed margin rule for uncleared swaps with corresponding rules in those jurisdictions. I am encouraged by the progress we are making and I hope that the final rules will be similar in most respects.

We also have other outstanding rules to finish regarding governance issues, capital and position limits. Regarding position limits, the law mandates that the agency adopt limits to address the risk of excessive speculation. In doing so, we must also make sure that market participants can engage in bona fide hedging. This is a significant and complex rule, and one where we are committed to taking the necessary time to get it right.

We have received substantial public input on this proposal. These comments address many issues and I will note a few. We have heard from market participants in particular about exemptions for bona fide hedging. We recognize hedging strategies are varied and complex, and we are considering these comments carefully. It has been suggested that we rely on the exchanges with respect to the review of applications for what are known as "non-enumerated" exemptions, and we are taking a closer look at this issue. Finally, it is important that we have accurate estimates of deliverable supply of a commodity, and we have also solicited and received public input on this issue, including estimates for many commodities.

Cross-Border Issues: The Challenge of Building a Global Regulatory Framework

Another key priority is working with our international counterparts to build a strong global regulatory framework. To achieve the goals set out in the 2009 G-20 commitments and embodied in the Dodd-Frank Act, global regulators must work together to harmonize their rules and supervision to the greatest extent possible. Since I joined the CFTC, I have made it a priority to work with our international counterparts on these issues.

The challenge of harmonizing rules across borders is best understood by remembering the unique historical situation we are in. The swaps market grew to a global scale without any meaningful regulation. So today, we must regulate what is already a global market. The new framework can only be implemented, however, through the actions of individual jurisdictions, each of which has

its own legal traditions, regulatory philosophy, political process, and market concerns. While the G-20 nations agreed to basic reform principles, there will inevitably be differences in specific rules and requirements. The challenge is to achieve as consistent a framework as possible while recognizing that our responsibility as national regulators is first and foremost to faithfully implement and enforce our own nation's laws. We should also recognize that in most areas of financial regulation, laws vary among nations. The fact is that, in the case of swaps, we have made great progress in harmonization, and, though it will take time, we will continue to do so.

Let me note a few of the things that are going on in our effort to work with our international counterparts. First, I have been personally committed to this effort. To that end, since I took office last June, I have made a number of trips to Europe and met several times with European and other international officials here in the U.S. Last week, I testified in Brussels before the European Parliament and met with European Commissioner Jonathan Hill with respect to the regulation of clearinghouses. Earlier this year, I visited Asia, where I met with government officials in Beijing, Hong Kong, Singapore, and Tokyo as well as with key market participants. These visits provide an opportunity to listen to others' views, identify issues of common concern, and work together to advance our shared goal of bringing the over-the-counter swaps market out of the shadows. I have also met with my counterparts from all over the world at board meetings of the International Organization of Securities Commissions in Europe and South America as well as the OTC Derivatives Regulators Group.

- Clearinghouse Recognition and Regulation

One of the most important cross-border issues before the Commission is clearinghouse recognition and regulation. The fact is that a small number of clearinghouses are becoming increasingly important single points of risk in the global financial system. This is an issue that transcends swaps. It is of equal concern to participants in the futures and options markets because the same clearinghouses handle clearing for many products.

We are continuing in dialogue with the Europeans to facilitate their recognition of our clearinghouses as equivalent. Such recognition is necessary in order for European firms to be able to continue to transact business in our markets. One key principle I have advocated in these discussions is that our existing framework, which requires that in certain circumstances, European clearinghouses that engage in substantial U.S. business must register with us and meet certain basic standards, is a good one that should be continued. The Europeans initially asked that we exempt their clearinghouses entirely from U.S. standards, even those protecting U.S. customers in the bankruptcy of a U.S. clearing firm.

The practice of dual registration and cooperative supervision of such large clearinghouses has worked well. It has worked to protect customers, it worked during the crisis, and it is a model on which the market has grown to be global. Fourteen clearinghouses are currently registered with the CFTC to clear either swaps, futures, or both. Five of those are organized outside of the United States, including three in Europe. One such European clearinghouse, which has been registered with us since 2001, now handles approximately 85% of swaps clearing. In addition, the CFTC is now reviewing three additional registration applications from clearinghouses outside the United States.

After considerable discussion, the Europeans have agreed that the framework of dual registration and cooperative supervision should not be dismantled. We have instead worked out a framework for substituted compliance for European clearinghouses. We worked hard to come up with that substituted compliance framework, and I believe that, if we can work through the rest of our differences, we have a framework that is satisfactory to both the EC and the CFTC.

Following that agreement, the European Commission advised us that it was still not able to find our supervisory regime equivalent and grant recognition to our clearinghouses because it is concerned that the margin methodologies used by U.S. clearinghouses are inferior to theirs and create an unacceptable level of risk to Europe. We disagree, and our discussions have been focused on these issues, in particular our respective rules on margin methodology for futures. We follow a policy of gross collection and posting of customer margin for a minimum one-day liquidation period. That is, the clearing members must pass on to the clearinghouse the full amount of initial margin for each customer. The Europeans methodology is based on a two-day liquidation period, but it permits netting: if one customer's exposures offset another's, then the clearing member can post initial margin netted across customers. To see how these different approaches compare, we provided them an analysis using actual data for seven days.

We reconstructed what the required margin would be under each regime for the nine largest clearing members of one U.S. clearinghouse. These clearing members represent about 80% of the total customer margin. And what we found was that one-day gross was substantially higher than two-day net for each clearing member, and for each day. That is, the total amount of customer margin under one-day gross was as high as 421% of the amount under two-day net, and was never less than 160% of that amount. We have since looked at two other clearinghouses, and found even larger percentage differences.

In addition, it is also important to remember that margin requirements are only one part of an overall supervisory framework we have to mitigate risk. There are many other aspects of our supervisory framework that enhance financial stability and customer protection.

Our discussions continue and I am hopeful that we can bring this matter to a close soon.

- <u>Oversight of Swap Dealers and Margin for Uncleared Swaps</u>

Another important topic in the cross-border harmonization effort is oversight of swap dealers. In late 2013, we issued determinations of comparability with respect to the rules of six other jurisdictions – the European Union, Japan, Australia, Hong Kong, Switzerland, and Canada. These set forth the extent to which swap dealers that are registered with us can nevertheless comply with another jurisdiction's rules instead of our own, as a means to avoid duplicative or conflicting regulation. We will continue to look at other jurisdictions' rules as those are finalized.

Our proposed rule on margin for uncleared swaps is another area where we are looking to harmonize our rules with those of other jurisdictions as much as possible, as I noted earlier. We were active in the development of international standards in this area, and have worked with other jurisdictions, in particular Europe and Japan, on the specifics of our respective proposed rules. This is an important example of working internationally so that the rules are as similar as

possible from the beginning. While our respective final rules will not be identical, I am hopeful that they will be similar in many respects.

- Reporting

As I noted earlier, there is a lot of cross-border work going on in the area of reporting. The number of data repositories across various jurisdictions – four in the U.S. plus more than 20 others internationally – as well as all of the participants around the world who must report make moving forward in this area more important than ever. We and the European Central Bank currently co-chair a global task force that is seeking to standardize data standards internationally. We are working to achieve consistent technical standards and identifiers for data in trade repositories. While much of this work is highly technical, it is vitally important to international cooperation and transparency.

- Trading Rules and Foreign Boards of Trade

While we have issued our swap trading rules, other jurisdictions generally have not done so. As I indicated earlier, as other jurisdictions develop their rules, we are open to trying to harmonize rules as much as possible consistent with our statutory responsibilities.

Although it pertains to the futures and options markets more than swaps, another key element of our cross-border effort is to recognize foreign exchanges in order to enhance opportunities for the trading of futures globally. We have recently taken some important actions in this area.

The CFTC does not generally regulate the trading of futures by U.S. persons on offshore exchanges. If a foreign futures exchange wishes to provide direct electronic access to people located in the U.S., we have in the past required the exchange to apply for relief from our registration requirements. We have formalized that process, and now foreign exchanges, which we refer to as foreign boards of trade or FBOTs, can be officially registered with us.

Under this new process, the CFTC has approved FBOT registration applications for the Tokyo Commodities Exchange (TOCOM), Bursa Malaysia, and Singapore Exchange (SGX). These approvals recognize the increasing interconnectedness of the global derivatives markets. More generally, the FBOT registration approval also demonstrates our commitment to a coordinated regulatory approach that relies on foreign supervisory authorities and ongoing cooperation.

- Benchmarks

Another cross-border issue that we have been focused on is the potential regulation of financial benchmarks and indices by the European Union (EU). In our markets, thousands of contracts reference benchmarks and indices, such as LIBOR, S&P 500 and Brent Crude. The integrity of benchmarks and indices is vital to our financial system. That is why we have focused on this issue in our enforcement efforts, as evidenced by our orders against banks that have tried to manipulate interest rate benchmarks like LIBOR and foreign exchange benchmarks. We have also worked cooperatively with foreign regulators in these enforcement actions, which I will return to in a moment.

We believe benchmarks should be administered in a manner that achieves transparency and integrity and minimizes the risk of manipulation. That being said, the European Commission has proposed legislation that would have adverse market consequences. In particular, benchmarks created by administrators located in countries outside the EU could not be used by European supervised entities, such as banks and asset managers, unless the European Commission determines that any non-EU administrator is authorized and equivalently supervised in the non-EU country. The United States does not have such a government-sponsored supervisory regime for benchmarks. Accordingly, in light of the EU's equivalence standards, the new proposed benchmark regulation could prohibit EU institutions from hedging using many products traded on US futures exchanges and swap execution facilities.

I have expressed these concerns to European officials. I have encouraged them to recognize that alternatives to government regulation of benchmarks can achieve the results they desire. For example, our law gives us the power to review new proposed contracts and determine whether they may be susceptible to fraud and manipulation, which authority enables us to review reliance on a benchmark. We also engage in surveillance which can be used to identify problems with benchmarks. Finally, as I noted earlier, we have engaged in robust enforcement efforts to hold those accountable who have manipulated or attempted to manipulate a benchmark. I have also encouraged European officials to consider the work of the International Organization of Securities Commissions (IOSCO) in this area, which the CFTC helped lead. IOSCO's Principles for Oil Price Reporting Agencies (PRA Principles) and Principles for Financial Benchmarks set forth standards that address methodology, governance, conflicts of interest, and disclosure. Many price reporting agencies and financial benchmark administrators have already begun voluntarily complying with these standards.

We must also balance the benefits of imposing standards regarding benchmarks with the costs of compliance with those benchmarks. I have encouraged European officials to consider focusing their standards on those benchmarks that are most widely used, so that smaller contracts are not subject to costs of compliance that could be prohibitive. It is especially important that we do not inhibit innovation in our markets by imposing upfront, excessive costs before a contract has even developed significant liquidity.

I hope that we can continue to work with our international counterparts to ensure benchmark integrity in a way that recognizes that most benchmarks are not administered by, or regulated by, a government agency.

Continuing to Fulfill our Traditional Responsibilities

A lot of what we do each day is to focus on surveillance and enforcement to prevent fraud and manipulation or other market abuses, in both the traditional markets we have long overseen as well as in the swaps market. Our compliance, examinations and registration work also makes sure that customers are protected, participants comply with their obligations and the markets operate with integrity and transparency. Let me highlight some key elements of these efforts.

- Enforcement and Compliance

A strong compliance and enforcement program is crucial to maintaining the integrity of our markets, as well as public confidence. As a nominee, I committed to having a robust effort in this area. And we have. The Commission has pursued cases covering a wide variety of potential market abuses and bad behavior, ranging from more common fraud and abuse like Ponzi schemes or precious metal scams that target retirees, to complex manipulation schemes driven by sophisticated, electronic trading strategies, to market price or benchmark manipulation, including through coordination efforts by leading banks.

Our priority has been to make sure that the markets we oversee operate fairly for all market participants regardless of size or sophistication. Fraud, manipulation, and abuse should have no place in our financial markets.

Let me note a few recent examples. Last month, the Commission and the Department of Justice brought civil and criminal charges against an individual who we believe engaged in spoofing and sought to manipulate the E-mini S&P 500 futures on repeated occasions, at times successfully. His activity contributed to the order imbalance in trading in E-mini S&P 500 futures that contributed to market conditions that led to the flash crash of 2010. We worked closely not only with the Justice Department, but also the FBI and the U.K. Financial Conduct Authority on this case.

In addition, last month, the agency along with our colleagues at the Department of Justice, the U.K. Financial Conduct Authority and New York's Department of Financial Services announced settlements with Deutsche Bank over charges of false reporting and manipulation of LIBOR, a critical, global benchmark interest rate, upon which trillions of dollars of contracts are indexed. This effort has been ongoing. The Commission brought the first LIBOR manipulation case in 2012, and collectively, the Commission has imposed over $4 billion in penalties against 13 banks and brokers to address LIBOR and foreign exchange benchmark abuses.

In addition to penalties, we ordered the banks to agree to implement reforms designed to prevent the recurrence of this behavior.

We have also directed self-regulatory organizations to strengthen their efforts to combat spoofing. The CFTC recently recommended, for example, that CME develop strategies to identify instances of spoofing and, as appropriate, pursue actions against perpetrators. The CFTC also recommended that CME maintain sufficient enforcement staff to promptly prosecute possible rule violations. The company should take measures to ensure internal deliberations do not delay disciplinary action.

We are also actively pursuing actions against those who try to perpetrate frauds against seniors and other retail investors. The use of our anti-fraud enforcement authority to address fraud in the precious metals space is one example. These schemes, which often target seniors concerned that they may outlive their retirement assets, purport to offer consumers the ability to buy precious metals like gold using pre-arranged financing. These transactions are typically not conducted on an exchange. They are typically structured so that, taking account of fees and interest, the precious metals would have to double in value year after year in order for the investor to make

any money. Even worse, in many cases, the transactions are entirely fraudulent: no precious metals are ever bought. In 2014, the Commission tried and won a case against Hunter-Wise, a Florida company that was a trailblazer in the use of this scheme. In addition to Hunter Wise, we have also taken action to shut down a host of boiler room operations used to identify and recruit potential victims. Our work is ongoing. Just last month, we announced a settlement resulting in restitution and civil monetary penalty of more than $9.6 million against Gold Coast Bullion, Inc. and its principal. We have pursued enforcement actions in 36 similar off-exchange metals cases since 2012.

We are equally focused on using our authority to ensure compliance with our rules, such as our reporting rules. Earlier this year, for example, we imposed penalties against a major bank for failing to abide by our reporting requirements.

Although our effectiveness is best measured by the quality, breadth and effect of the actions pursued, quantitative metrics give a picture of the activity. Overall, the CFTC filed 67 new enforcement actions during fiscal year 2014. We opened more than 240 new investigations. The agency obtained $3.27 billion in sanctions, including $1.8 billion in civil monetary penalties and more than $1.4 billion in restitution and disgorgement. Already in fiscal year 2015, the agency has obtained $2.5 billion in sanctions – an amount 10 times our current annual budget.

As a complement to these efforts, we have also taken steps to encourage individuals to help us detect fraud and other misconduct. The agency's whistleblower program, created by the Dodd-Frank Act is one example. The program provides payments – up to 30 percent of any sanction obtained – to eligible whistleblowers. This is a relatively new program so it is still growing. We believe the program will be an important tool going forward in identifying, investigating, and prosecuting violations of the law.

We are also working to help consumers be smarter investors and detect fraudulent schemes on their own. At the end of last year, we launched the CFTC *SmartCheck* campaign. This campaign is designed to help investors identify and recognize the most common schemes and the top signs of a fraudulent investment. The campaign includes tools, such as an interactive website, to help investors stay ahead of the fraud perpetrators. For example, investors can use the website to check the background of financial professionals and confirm whether any potential advisors have had past violations.

Going forward, market participants should understand that we will use all the tools at our disposal to ensure compliance with the law.

- <u>Responding to Market Developments</u>

Another example of the importance of the CFTC's role is what happened last month when the Swiss government removed the cap on the exchange rate between the Swiss franc and the Euro. The resulting 23% increase in the value of the Swiss franc roiled the foreign exchange markets. The CFTC closely monitored the markets and several firms in particular that were facing significant losses.

For cleared products affected by this development, CFTC staff immediately started conducting stress tests of open positions, and staff contacted registered clearinghouses as well as clearing members with large exposures. Despite the extreme price moves, all clearing members met their obligations to clearinghouses.

For uncleared products, after the CFTC learned that one firm, FXCM, had a significant capital deficiency, CFTC staff were on site at the firm and also worked closely with staff from the National Futures Association (NFA). Although it is not the agency's responsibility to help a troubled firm secure capital, the CFTC was in touch with FXCM continuously through the night and the next day concerning what actions the firm might take to stabilize its situation and meet CFTC capital requirements. The CFTC monitored the firm's efforts to obtain capital to insure that any capital proposed would meet CFTC requirements and cover customer obligations. The CFTC and the NFA also made sure the firm did not make any disbursements to the detriment of customers during this time. The CFTC also prepared for the necessary legal actions to protect customers to the fullest extent possible in the event the firm was unable to secure additional capital. The firm was able to obtain a capital infusion that satisfied CFTC requirements and thereby stay in business.

We are currently working with the NFA to determine whether changes are needed in the rules governing retail foreign exchange dealers to make sure that firms are operating responsibly and that customers understand the risks of these transactions.

Addressing New Challenges and Risks

Finally, I wish to discuss our work in addressing some new challenges and risks in our markets.

- Cybersecurity, Information Security, and Business Continuity

Cybersecurity is perhaps the single most important new risk to market integrity and financial stability. The examples from within and outside the financial sector are all too frequent and familiar: the latest include JP Morgan, Sony, Home Depot, and Target. The need to protect our financial markets against cyber attacks is clear. These attacks threaten privacy, information security, and business continuity, all vital elements of a well-working market. A successful attack at an exchange or clearinghouse could have significant adverse effects on our markets.

Accordingly, we are focusing on this issue in our examinations of clearinghouses and exchanges in particular to make sure they are doing all they can to address this risk. We are also focusing on business continuity and disaster recovery plans, as a well-executed disaster recovery plan will aid in the recovery from a cybersecurity event.

We recognize that our efforts are only part of what must be an overall effort by industry and government to address these risks. We work closely with other regulators on these concerns, through the Financial and Banking Information Infrastructure Committee (FBIIC), the cybersecurity and disaster recovery committee of federal financial regulators. To help ensure coordination between the government and the private sector in this important area, we work together with the FBIIC's private sector counterpart, the Financial Services Sector Coordinating

Council (FSSCC). We also encourage firms, markets, and clearing organizations registered with us to participate in the cybersecurity information sharing that is conducted across the financial sector through the private sector Financial Sector Information Sharing and Analysis Center (FS-ISAC).

We must determine the best ways to leverage our limited resources to enhance the various efforts that are already going on. Therefore, we have focused on the following actions as well:

- We require exchanges, clearinghouses, and SEFs to maintain system safeguards and a risk management program, to notify the Commission promptly of incidents, and to have recovery procedures in place. Systemically important clearinghouses, for example, must have plans that enable them to recover and resume daily processing, clearing and settlement activities no later than two hours following a disruption. They must also maintain geographic dispersal of personnel resources to aid in recovery efforts following a disruption.

- We conduct system safeguards examinations, using industry best practices, to determine compliance with these requirements, and we monitor remediation efforts if any issues are identified during the examination process.

- We are making sure the private companies that run major exchanges and clearinghouses are doing adequate testing themselves of their cyber protections, such as control testing, penetration testing, and vulnerability testing. Commission staff recently held a roundtable to discuss this issue, and received very useful input. I expect that we will propose a new rule on this subject later this year, which would set forth requirements on testing to insure that best practices are being followed.

- <u>High Frequency and Automated Trading</u>

We have witnessed over the last several years a dramatic increase in electronic and automated trading in our markets. Futures markets in the US are now largely electronic. Many exchanges have closed their trading floors, and traditional pit trading is now restricted to a small subset of niche products – complex options strategies that need human facilitation. Orders generated by automated systems account for over 90% of the traded volumes in financial futures.

The Commission has responded to the growth of electronic and automated trading in CFTC-regulated markets through a number of measures that address key steps in the order placement and trade execution process. For example, in April 2012 the Commission adopted rules requiring clearing member futures commission merchants, swap dealers, and major swap participants to establish risk-based limits based on position size, order size, margin requirements, or similar factors for all proprietary and customer accounts. Firms are also required to screen orders for compliance with risk limits via automated means when such orders are subject to automated execution. The Commission also adopted rules to ensure that exchange trade matching algorithms are regularly tested. In June 2012 the Commission adopted rules requiring

exchanges to establish and maintain risk control mechanisms to help reduce the potential risk of price distortions and market disruptions, including trading pauses and halts. The Commission also adopted new risk control requirements for exchanges that provide direct market access to clients, including rules requiring they have systems reasonably designed to facilitate futures commission merchants' management of financial risk.

The Commission is currently considering whether additional actions are necessary. We are considering comments received in response to the Concept Release on Risk Controls and System Safeguards for Automated Trading Environments that we issued in September 2013. The Concept Release seeks input on a range of protections for both firms and exchanges, including additional pre-trade risk controls; post-trade reports; design, testing, and supervision standards for automated trading systems that generate orders for entry into automated markets; market structure initiatives; and other measures designed to reduce risk or improve the functioning of automated markets. Commission staff has continued to carefully review risk controls for automated trading and to consider what further steps may be necessary to further reduce risks in electronic and automated trading. We will make a determination in the near future on what additional measures, if any, might be necessary to address automated trading.

Relationship with the National Futures Association and other SROs

In much of what we do, we coordinate with self-regulatory organizations, including in particular, the National Futures Association (NFA), so that we can benefit from their expertise and leverage our own resources. Since I took office, I have also focused on working with the NFA so that they can take on further responsibilities, including with respect to review of required filings and financial information of futures commission merchants and swap dealers, assistance with examinations, review of swap valuation disputes, and other matters.

The NFA and other SROs are a very important part of the overall regulatory framework. Recently, for example, we worked very closely with the NFA when the Swiss franc was unpegged, to monitor potential problems at retail foreign exchange dealers. We are also working with them now on changes to the rules governing such firms to insure better protection of customers. To the extent that SROs are able to take on additional responsibilities, it enables us to leverage our resources for other priorities.

Of course, whatever the self-regulatory organizations do is subject to our oversight. The scope of our responsibilities is distinct. That means regular engagement and review of their activities. But by having them take on greater responsibility we can insure better protection of the public interest.

Retrospective Regulatory Review

Concurrent with our other work, we are engaged in a retrospective regulatory review. In response to Executive Order 13563, the CFTC developed a two-step program of retrospective review, which was announced in the Federal Register on June 30, 2011. First, as part of its

implementation of financial reform under Dodd-Frank, the Commission reviewed many of its regulations to determine the extent to which these regulations needed to be modified to conform to the Dodd-Frank Act. This review resulted in modifications to a number of existing rules, both to implement regulatory changes mandated by the Dodd-Frank Act and more generally to update and modernize those rules. For example, the CFTC made a number of changes to reflect market developments and to codify standard or commonly-accepted industry practices.

We have now begun step two of our review during which we will consider the remainder of CFTC regulations. As part of this process, the Commission will solicit public comment to determine which rules may need to be modified or rescinded. Following this review, we will follow up with rulemaking proposals as necessary.

Resources and Budget

Advancing the goals I have outlined and fully implementing the new regulatory framework depends on having resources that are proportionate to our responsibilities. The CFTC received a budget increase for FY 2015 for which we are very grateful. It is being put to good use. But in my view, the CFTC's current budget still falls short. The CFTC does not have the resources to fulfill our new responsibilities as well as all the responsibilities it had – and still has – prior to the passage of Dodd Frank in a way that most Americans would expect. Our staff, for example, is no larger than it was when Dodd-Frank was enacted in 2010.

We are fortunate to have a talented and dedicated professional staff, and we keep Teddy Roosevelt's adage in mind – to do all we can, with what we have, where we are. But the significant limits of our current budget are evident.

Among other things, in the absence of additional resources, the CFTC will be limited in its ability to:

- Perform timely and thorough examinations of critical market infrastructure such as clearinghouses and exchanges, which are so important to our financial system and to financial stability, as well as intermediaries that hold billions of dollars in customer funds to ensure that they are protecting customer interests and operating in compliance with Commission requirements.

- Engage proactively on emerging risks like cybersecurity. The CFTC needs resources to conduct compliance examinations of cybersecurity programs of regulated entities, help develop best practices, and respond when attacks occur.

- Respond quickly to the concerns of commercial end-users. Our ability to provide interpretations, exemption and no-action relief, and timely review of submissions is constrained when the same individuals responsible for these functions are also tasked with significant other responsibilities.

- Maintain and improve vital information technology systems and resources. The CFTC must be able to keep up with the markets we oversee, including up-to-date technology

resources, and the staff – including analysts and economists, as well as IT and data management professionals. One-third of our budget – nearly 40 percent of the requested increase for FY16 – is for data and technology. Without additional resources, the CFTC will be less able to engage in the necessary level of market surveillance and oversight to detect excessive risk, fraud, manipulation or other abusive practices.

- Engage in the necessary level of risk surveillance and oversight to ensure the financial integrity of the clearing and settlement process and to protect customers in the event of a clearinghouse or clearing member default.

- Engage in robust enforcement efforts with respect to fraud, manipulation, abusive or disruptive practices, or other threats to market integrity and customer protection.

Simply stated, without additional resources, our markets cannot be as well supervised; participants and their customers cannot be as well protected; market transparency and efficiency cannot be as fully achieved. The many businesses that rely on the derivatives markets the CFTC oversees depend on the Commission to do its job efficiently and sensibly. The Commission's budget is a small, but vital investment to make sure these markets operate with integrity and transparency.

Conclusion

Thank you for inviting me today. The Commission is grateful to this subcommittee for its support of the agency's work.

The United States has the best financial markets in the world. They are the strongest, most dynamic, most innovative, and most competitive – in large part because they have the integrity and transparency that attracts participants. They have been a significant engine of our economic growth and prosperity. The CFTC is committed to doing all we can to strengthen our markets and enhance those qualities. I look forward to continuing to work with you on this important responsibility.

I look forward to answering any questions you may have.