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REGULATORY ISSUES IMPACTING END-USERS AND MARKET LIQUIDITY

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

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REGULATORY ISSUES IMPACTING END-USERS AND MARKET LIQUIDITY

Thursday, May 14, 2015

UNITED STATES SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The committee met, pursuant to notice, at 10:05 a.m., in room 106, Dirksen Senate Office Building, Hon. Pat Roberts, Chairman of the committee, presiding. Present or submitting a statement: Senators Roberts, Boozman, Hoeven, Perdue, Grassley, Thune, Stabenow, Brown, Klobuchar, Bennet, Heitkamp, and Casey.

STATEMENT OF HON. PAT ROBERTS, U.S. SENATOR FROM THE STATE OF KANSAS, CHAIRMAN, U.S. COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Chairman ROBERTS. Good morning. I call this meeting of the Senate Committee on Agriculture, Nutrition, and Forestry to order.

Welcome to our first hearing related to the Commodity Futures Trading Commission, the CFTC.

July marks the five-year anniversary of passage of the Dodd-Frank Act. Not too long after, this committee began reviewing its impact on farmers and ranchers and end-users. We have had several hearings with numerous on-the-ground witnesses, and to nobody's surprise, have discovered that Dodd-Frank in its implementation placed many burdens on our end-users, our farmers and our ranchers, and yet the Congress has not sufficiently acted to address these hardships.

As a refresher for us all, the term "end-user" refers to those participants who use derivatives to hedge the commercial risks associated with their normal operations, such as a grain company buying a farmer's wheat, or an electric cooperative providing power to rural homes. End-users offset their normal operational risk by engaging in derivatives transactions.

They did not cause the 2008 financial crisis, nor were they ever blamed for contributing to it. Because of this, Congress did not intend for them to be subject to Title VII of Dodd-Frank. However, these end-users have been captured by many rules and regulations stemming from the regulatory implementation of Dodd-Frank.

So, today, we will continue our focus on regulatory issues impacting end-users and market liquidity. We will discuss the concerns of and increased regulatory burdens on the end-user community over the last five years. This hearing will help build the record for what Congress should address in legislation and what are overdue in ac-

complishing, that is, reauthorizing the CFTC, which is our main goal as of this morning.

CFTC reauthorization is a priority. I intend to work with Senator Stabenow and the members of this committee to come up with a bill that addresses our end-user-related concerns and fulfills our responsibility of reauthorizing the Commission. We need end-users and those who provide the platform for them to manage their risk to help us craft an appropriate pathway forward that protects the market from manipulation while not stifling commerce. I intend to keep working on legislation that eases the burdens on those who provide the crucial services our farmers and ranchers need to effectively operate in our fast-moving economy.

In that spirit, I, along with Senators Perdue and Cochran, have introduced a bill that eases the regulatory requirements of certain transactions executed by centralized treasury units that manage the risk of end-users and its affiliates. This bill is based on bipartisan legislation offered in previous sessions and we hope it will be part of a bipartisan reauthorization package. The committee's reauthorization process is the appropriate vehicle to address the regulatory concerns of our end-users, again, our farmers and ranchers.

Another pertinent topic under review today is the fear of losing U.S. market liquidity. Many participants are concerned with the current and future state of market liquidity and what that means for U.S. competitiveness compared to foreign markets. For example, increased costs of clearing, lack of on-exchange swaps participation, future commission merchant consolidation or concentration, lack of mutual regulatory recognition by foreign governments—I could read that three times—and more liquidity moving to foreign jurisdictions are all causes of concern. We must find solutions so that our U.S. markets remain transparent, remain competitive, and remain resilient.

I truly appreciate our witness being here today. CFTC Chairman Massad will testify on our first panel. Mr. Chairman, thank you so much for taking time out of your valuable schedule to come and be with us.

Since becoming Chairman, he has been busy addressing many end-user-related concerns. I encourage the Chairman to continue his positive efforts and to keep up the good work and to make sure that our U.S. markets remain the most competitive in the world.

I also look forward to hearing from all of our witnesses on our second panel. The committee appreciates you giving us your perspective on current regulatory issues and market liquidity.

I now turn to my colleague, Ranking Member Stabenow, for any opening remarks that she may have.

STATEMENT OF HON. DEBBIE STABENOW, U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator STABENOW. Well, thank you, Mr. Chairman, for holding this very important hearing. We both share a desire to support end-users and to allow the system to be able to work in managing risk.

Thank you Chairman Massad and the end-user representatives that are going to be testifying today. We look forward—as representatives of our nation's growers and manufacturers and pro-

ducers, it is very important that we hear what is working and what is not working.

A little history. The Commodity Futures Trading Commission was established in October of 1974 when a great Michigan statesman, President Gerald Ford, signed the Commodity Futures Trade Commission Act into law. As the Commission celebrates its 40th anniversary this year, it is important to remember how we got where we are in the regulation of futures trading and consider what must be done to ensure the safety and soundness of this important market moving forward.

In 1922, the USDA established an internal department, the Grain Futures Administration, to administer the Grain Futures Act. It is important that the committee reflect on this fact, I think, because the CFTC traces its history to a small agency within the Department of Agriculture, and for good reason. Before then, regulated futures were very much controlled by farmers and producers who used futures contracts to protect their harvest against unexpected price fluctuations and weather conditions. But, we are far removed from those simpler days of agricultural futures, and that fact is evident when we look at the group of end-users with us today.

Every member of the Agriculture Committee takes great pride in supporting our nation's farmers and ranchers, pride in getting a farm bill done together, and having a committee that works together in a bipartisan way. This responsibility and priority will never be in doubt.

It is also important, I believe, that it is time that this committee think beyond the CFTC's roots in the agency that President Ford helped create in 1974 to replace what he believed was an inadequate regulatory system for the futures market.

The CFTC has become the premier global regulator, and it is important that we acknowledge this reality by providing the agency with the tools and the resources it needs to carry out very important responsibilities. As our country and economy continues to recover from the 2008 financial crisis, we must be committed to policies that protect taxpayers from risky financial practices that got us into the crisis in the first place. Rather than trying to keep pace with the evolving markets, I believe we must strive to be ahead of them. There is too much at stake. We cannot afford another crisis that costs the loss of even one job, let alone eight million.

Recent CFTC enforcement actions demonstrate this need. Both domestically and internationally, the CFTC is the cop on the beat. The enforcement cases show that bad actors do still exist and will, as they have for many years, and they seek regulatory gaps that allow for the manipulation of market prices that affect everything from the bread on our shelves to the gasoline in our cars. So, we need the CFTC. We need the CFTC to be adequately supported and funded and have the tools it needs, and we need to make sure it is focused in the right direction on where the risk is.

As we move forward toward reauthorization, I look forward to working with Chairman Roberts and members on the committee, as we always do, in a bipartisan way, to ensure the CFTC is equipped with the tools it needs to foster open, transparent, and competitive markets that our end-users feel confident that they can

use, and that is going to allow our end-users to manage their commercial risk in a safe, reliable way.

I look forward to the hearing. Thank you, Mr. Chairman.

Chairman ROBERTS. Thank you, Senator.

Welcome to our first panelist before the committee this morning, the Honorable Tim Massad, Chairman of the Commodity Futures Trading Commission. The Chairman was sworn in on June 5, 2014, after being confirmed by the United States Senate, as both Chairman and Commissioner of the CFTC. Previously, Mr. Massad was nominated by President Obama and confirmed as the Assistant Secretary for Financial Stability at the U.S. Department of the Treasury. I am looking forward to learning about the CFTC's progress on regulatory issues impacting end-users and market liquidity.

Welcome, Mr. Chairman. Please proceed.

STATEMENT OF HONORABLE TIMOTHY MASSAD, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. MASSAD. Thank you, Chairman Roberts, Ranking Member Stabenow, and members of the committee. I appreciate the opportunity to testify today regarding the work of the CFTC and I am pleased to be here on behalf of the Commission.

Let me begin by thanking our staff for their hard work and dedication, and I also want to thank my fellow Commissioners for their efforts.

You have invited me to discuss the impact of the CFTC's work on end-users and market liquidity. The topic goes to the core of our mission. The derivatives markets the CFTC oversees are profoundly important to our economy. These markets shape the prices we all pay for food, energy, and other basic needs. They enable businesses of all kinds to manage risk, whether it is a farmer locking in the price for his crops, a utility managing its fuel cost, or an exporter hedging foreign currency risk. As the primary regulator of these markets, we should constantly ask ourselves, how well are these markets serving the needs of the many businesses that depend on them?

We also saw in the global financial crisis that the over-the-counter swaps market could generate excessive risks, risks that were not seen nor well understood and that helped to bring our financial system to the brink of collapse. Mr. Chairman, as you noted, commercial end-users were not responsible for those risks, but they and the American people generally paid a heavy price as a consequence of that crisis, and Congress, therefore, expanded our responsibility in order to bring oversight and transparency to the swaps market.

So, our job today is to fulfill those new responsibilities while still making sure that these markets serve the needs of commercial end users. In carrying out that work, we must also recognize how the traditional markets we have overseen have grown dramatically in size, complexity, and technological sophistication. The CFTC oversees markets in over 40 physical commodities in addition to 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 tenders and associated options are included.

The number of actively traded contracts has doubled since Dodd-Frank was enacted and increased six times over the last ten years. The amount of customer funds that must be protected has increased nearly 50 percent since 2010. Today, not only is almost all trading electronic, but in many products, a majority of trading is conducted through highly sophisticated automated programs. This is true not just for financial futures, but also for agricultural and energy commodities. The changes in our marketplace do not alter our mission, but they make the task of fulfilling that mission more challenging.

I believe all four of us on the Commission today are committed to making sure these markets serve commercial end users effectively and efficiently. To that end, we have sought to make sure that our rules do not impose undue burdens or unintended consequences for these participants. We have taken several actions over the last year, including the following.

We have addressed industry concerns regarding contracts with embedded volumetric optionality. We recently proposed amending our rules regarding trade options to eliminate unnecessary reporting requirements. We made sure that commercial firms can take advantage of the statutory exemptions to the requirements for mandatory clearing and trading of swaps when they book transactions through Treasury affiliates. We made it clear that new rules on margin for uncleared swaps would not apply to commercial end-users.

We have addressed end-user concerns in a variety of other areas, as well, such as reporting and recordkeeping obligations, the posting of collateral with clearing members, the ability of local energy companies to access the energy swaps market, and the ability of firms to hedge in highly illiquid markets. We will continue to engage with market participants to make sure our regulatory framework is working for end-users and protecting the public.

We are also working in many other areas so that these markets have sufficient liquidity and work well for commercial firms. In the interest of time, I will just briefly note them here, but I would be happy to discuss them with you.

Just last week, I returned from Brussels, where I met with many European officials on cross-border issues. We are working to harmonize our rules with those of other countries as much as possible and seeking to make sure American firms are not disadvantaged in the global marketplace.

We are making changes to the swap trading rules to enhance trading of swaps and to attract participation and liquidity.

We are working to make sure clearinghouses are resilient, and we are focused on the costs of clearing and trading, especially for smaller participants.

We are focused on cybersecurity, perhaps the number one risk to financial stability today.

We are engaged in robust enforcement and surveillance efforts so that we do all we can to deter fraud and manipulation and promote integrity in our markets. Since 2012, the Commission has imposed over $4 billion in penalties against 13 large banks and brokers due

to manipulation of key global benchmarks. Already in fiscal year 2015, the agency has imposed $2.5 billion in sanctions, an amount ten times our current budget. These fines and penalties go directly to the U.S. Treasury and are not available to fund our budget.

The United States has the best derivatives markets in the world and we are determined to do all we can so that they continue to thrive and serve the needs of the businesses that depend on them. I look forward to working with you toward that goal.

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

[The prepared statement of Mr. Massad can be found on page 74 in the appendix.]

Chairman ROBERTS. Well, thank you, Mr. Chairman. We appreciate your testimony and, again, for taking the time to join us today.

I know that you have spent a lot of time addressing end-user issues since becoming Chairman. I thank you for that. However, end-users are not, at least with the contact with many members on this committee, are not entirely happy with the CFTC's proposed changes to the decades' old bona fide hedging definition. If the final definition of a bona fide hedge is too restrictive, how will end-users be able to appropriately manage their risk if they cannot get an exemption from position limits? Anticipatory hedging, as you know, sir, is crucial to managing an end-user's risk. We encourage the CFTC to treat anticipatory hedging consistently with the original intent of Congress. Would you care to comment?

Mr. MASSAD. Certainly, Senator. Thank you for the question. We are very committed to making sure that a final position limits rule provides for adequate bona fide hedging. That is critical, and it is also Congress' direction to us. We have spent a lot of time looking at this issue and talking with industry participants and getting a lot of comment. I have done this as Chair of the Agricultural Advisory Committee, where we committed a special session of it. We have done it through our Energy and Environmental Markets Committee. We have had a special roundtable on it. We have gotten many, many comment letters that we are reviewing, and we are taking our time to really digest all that input so that we get this rule right.

It is a very complicated rule. Anticipatory hedging is part of that. The process for how you get exceptions, even insofar as we will have specific exceptions in the rule, or specific provisions in the rule for bona fide hedging, there is also a process called non-enumerated exemptions and we are looking at that, trying to make sure that will be an efficient process.

So, I am very committed to making sure that we end up in a place where market participants can engage in bona fide hedging. It is critical.

Chairman ROBERTS. Do you have a time frame?

Mr. MASSAD. Not precisely, Mr. Chairman. I want to make sure that we get this right and we are going to take our time to do that.

Chairman ROBERTS. Well, we want you to get it right, and if you will please work with us, we would appreciate that very much.

For decades, the Commodity Exchange Act and the CFTC regulations have required that customer margin posted for cleared deriva-

tives must remain segregated from the bank-affiliated clearing member's own funds and that such margins should be treated as belonging to the customer. My question is, why do you believe the banking regulators are now assuming that this segregated customer margin can be used by the bank as leverage, which seems to contradict CFTC requirements? Did the banking regulators consult with the CFTC prior to finalizing these regulations? Can you give the committee a status update on your latest interactions with the banking regulators?

Mr. MASSAD. Thank you for the question, Mr. Chairman. I am very concerned about the issues you have raised and I have expressed that concern both to the bank regulators, the heads of all the agencies, as well as publicly. We have got to get this right.

I understand their objective, which is to have a leverage ratio as a backstop to risk weighting that, basically, does not have exceptions to it. But, nevertheless, as you point out, customer margin, cash margin, is segregated. I think we need to take that into account, particularly because we have made it a policy to encourage clearing here. So, we must make sure we do not have a rule that is cutting against that.

We are engaged in dialogue with the regulators on this. I cannot say for sure where that will go, but we are very focused on this and believe we need to make sure we balance these objectives.

Chairman ROBERTS. I appreciate that. Please keep in touch.

Turning now to international regulatory harmonization, can you please elaborate on recent efforts to ensure our markets remain competitive and liquid. You have just come back from a trip discussing that. Furthermore, how has Dodd-Frank impeded data sharing among the various jurisdictions? Is there a way for Congress to revisit the Act and address this issue?

Mr. MASSAD. Well, thank you for the question, Mr. Chairman. Let me address all those parts of it.

First of all, I did just come back from Brussels, where I was focused on discussions with European officials on clearinghouse recognition. They still have not recognized our clearinghouses, which means that unless and until they do that, there is a possibility that European firms would not be able to transact business.

There have been a couple of issues in that discussion. One was they asked us to look at our framework insofar as there are certain instances where our rules apply to their clearinghouses and they asked us to develop a framework of substituted compliance, which we agreed to do. We have basically agreed on that and we are prepared to offer that, assuming we settle the other issues.

However, they have also raised concerns with our margin—what we call our margin methodologies, the process of how we collect—how we determine how much margin to collect from customers. Now, they did that because they focused on one particular aspect of the rules instead of looking at the whole rule set, and we actually have done a lot of analysis, which I have explained to them when I was over there, and there is actually my speech and a lot of diagrams about this posted on our website, that explain that, actually, our system is stronger than theirs. We actually have a much better system, in our minds, and I believe our methodology here

and our systems overall for risk mitigation are the gold standard in the world.

So, I think we have made some progress in educating them about those issues and we have agreed on a path forward in terms of analyzing this, because they wanted us to, basically, collect more margin from customers, which would have hurt American competitiveness, hurt liquidity, hurt smaller participants in particular, and not really contributed to the overall stability of the system. So, that is where we are on that.

There is a lot of other work going on in other areas across border harmonization. You asked about the reporting issue. We are working on that. There is quite a bit of work going on there to harmonize standards, and I think we are making very good progress there.

In other areas, in trading, for example, in the trading rules, it is difficult there because Congress mandated us to do a rule. The agency was required to do it within a year. The agency published those rules on trading, but no other jurisdictions really have. So, when you have a global market and one jurisdiction creates trading rules but no one else does, it is kind of like the sound of one hand clapping. I mean, there is nothing for us to harmonize to yet. So, we are looking at what we think they are going to do and we are prepared to try to work to make sure we harmonize those rules, as well.

So, there is a lot going on in cross-border. Another thing that is going on is on the rule for margin for uncleared swaps, not what we clear, but what is uncleared. I have been very committed to trying to get those rules as similar as possible from the get-go, so our staff has been working with staff in Europe and Japan on that.

I hope I answered all the parts of your question.

Chairman ROBERTS. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, and thank you again, Chairman Massad, for all of your work, and you and I have talked about the issues you just raised and I appreciate your focus on that.

Since you were sworn in last June, you prioritized end-user relief, and I appreciate that very much. You mentioned some of the issues in your statement. In your opinion, have the affected end-user groups been satisfied with what the Commission has done to this point, and I am wondering if you are still hearing from them on the actions that you have already put in place in terms of rules or——

Mr. MASSAD. Thank you for the question——

Senator STABENOW. —think you have resolved some of those issues.

Mr. MASSAD. Yes. I think we have, Senator. I think they have been very pleased by a number of the actions we have taken. I am sure there are still some areas where they would like to see us take further action and we are happy to engage with them on those things.

Markets change. Markets evolve. That is why I think it is important for us to always be listening to market participants, but also to have the flexibility to try to respond quickly as we identify con-

cerns. So, I think we have made tremendous progress here, but I am very committed to continuing to engage with industry on it.

Senator STABENOW. One of the other issues that has come up is how quickly can things change. So, you have done a number of things that are very important. We appreciate the focus and the actions that you have taken, but can those be easily changed or can end-users count on the rules that have been put in place?

Mr. MASSAD. Oh, absolutely. I mean, most of what we have done has been through the rulemaking process, and to change that, you must go through the rulemaking process.

Senator STABENOW. That is not a short process.

Mr. MASSAD. No, it is not a short process, and it involves notice and comment and there is opportunity for public input.

Senator STABENOW. Thank you.

I would like to talk for a minute about the current civil penalty authority that you have as we move forward with reauthorization. Does the current authority produce enough of a deterrent for bad actors, in your judgment, or given the stakes involved, is the current penalty structure really just viewed as the price of doing business? Secondly, that leads to should we be increasing penalties for first-time violators or repeat offenders as we look at reauthorization?

Mr. MASSAD. Very good questions, Senator. Yes, I think we should. The current penalty structure for most things is $140,000 for a violation. Now, for certain types of things—manipulation—it is higher. But, $140,000 is just not appropriate, given the size, scale, complexity of these markets. We need to have a penalty regime that serves as an adequate deterrent. You can look at increasing those numbers. You can look at basing them on the loss that is caused by the violation, or the gain. You can also do formulas based on triple the gain or triple the loss, that sort of thing. But, I think we need to modernize those penalties, given the growth in complexity of these markets.

Senator STABENOW. Thank you.

You and I spoke several times in the past year about clearinghouses——

Mr. MASSAD. Yes.

Senator STABENOW. —both from a risk standpoint as well as a regulatory standpoint, and back to your trip to Brussels last week, trying to find a solution with our European counterparts on clearinghouse recognition, can you speak to some of the other outstanding issues that are yet to be resolved and when you expect an agreement, and let me just add further that from the risk angle, Dodd-Frank resulted in the concentration of significant amount of clearinghouse risk and I am looking forward to working with you around this, but as much as clearinghouses have brought a great deal of safety and transparency to what was a shadow market, it is also important that Congress and regulators make sure we are not creating a new risk environment that would lead to another financial crisis as a result of concentration. So, could you speak a little bit more to those issues.

Mr. MASSAD. Sure. So, the focus of the conversation is about these margin methodology issues, the methodologies we use to determine how much margin is collected from customers as well as

from the clearing members themselves and then posted to the clearinghouse versus how they do it. There are differences in how each regime works. But, as I say, we went through some analysis, because they felt at first their system was stronger than ours, and we actually did a lot of analysis to show that our system was collecting—on the customer side, was collecting and posting to the clearinghouse more. It was not costing the customers more, but it was, effectively, because we do what is called gross posting, you were making sure the clearinghouse was better protected.

So, there are still a lot of little issues in that we are looking at, but hopefully, we have limited it to that set of issues, how margin is collected by the house members, meaning the clearing members themselves, how much they have to post, and how you treat, for example, house affiliates. So, these are pretty technical issues and the issue really goes to how much can we minimize differences in our two regimes to avoid any issue of regulatory arbitrage.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman ROBERTS. Senator Perdue.

Senator PERDUE. Thank you, Mr. Chairman, and thank you, Mr. Massad.

First of all, I have to tell you, I am one of your biggest fans. I really appreciate what you are trying to do right now. You know, in my state, we have got a lot of end-users and they have been telling me over the last two years some of the draconian overreaches of the last few years of the CFTC. I realize what you are trying to do is find a balance, and I welcome that. I look forward to working with you to take care of some of these regulatory excesses.

But, I have to put in perspective my question. I have a question on end-user here I want to get to, but it seems to me that we have had a series of situations in the United States history, in the last 50 years, especially, where we have an economy and people, players in the economy, and we get a situation that causes a crisis, and then we have a draconian overreach in Washington. We saw it with Sarbanes-Oxley. We see it with Dodd-Frank. Now, we are trying to pull back and find a balance again in your area, and I applaud that.

I am a little troubled that the measures of success are the amount of fines—I have to say that personally—but I hope that we will also get to a point where we talk about we get normal end-users back to a normal life of doing business that were no part of the draconian things that happened in 2008 and 2009.

I have a question about the end-user definition. If you look up in Dodd-Frank, the Act itself, you will not find any definition. The closest you find is the end-user clearing exception, I believe. The CFTC's regulations refer to the end-user clearing exception provision in Dodd-Frank to identify end-users.

The problem with that is, it does not include everybody. It excludes dozens, maybe hundreds of end-user entities that use CTUs. You have provided a "no action" relief to end-users, and that is welcome. That is very much appreciated, and that is why I am speaking to that. It seems to me that you are trying to find a balance here to take care of the bad actors, but also not wrap up the bona fide people who are trying to use it properly. That is very much appreciated.

But, does "no action" relief really fix the underlying problem? Do we need to do something more statutorily? What really should be done to fix this thing permanently, in your opinion?

Mr. MASSAD. I think "no action" relief is a very important tool in our tool kit and I think we have used it appropriately. But, we are also looking at this issue in other ways. For example, Senator, with respect to the rules on margin for uncleared swaps, we are making sure that does not—that requirement is not imposed on commercial end-user firms, which is Congress's intent. We work with the bank regulators, because we are supposed to harmonize our rules with theirs, to make sure that was the case. We are looking at the consequences to end-users on some of our reporting requirements and lessening reporting requirements in certain areas, and again, doing that through rulemaking.

So, I would be happy to visit with you further on particular concerns, but I think we are very focused on this issue and we are very focused on making sure that the regime we are trying to put in place here, which I think is a very good one in terms of bringing transparency and oversight to the swaps market, should, at the end of the day, make this market better for end-users. It should not burden them with inappropriate burdens and costs.

Senator PERDUE. So, for future Chairmen of the CFTC, you think the current language is adequate to protect those end-users?

Mr. MASSAD. Well, I would be happy to visit. If you are talking about particular provisions, I am not quite sure which provisions you are talking about, so I would be happy to visit with you on that.

Senator PERDUE. That would be great.

Thank you, Mr. Chairman. Thank you.

Chairman ROBERTS. Senator Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman, and thank you, Ranking Member Stabenow, for the chance to have a few questions about an issue that a lot of people would not think the small state of North Dakota would be concerned about end-users. But my rural electric co-ops and my farmers every day use this as a risk management tool, and having appropriate end-user provisions is absolutely critical to that tool that is essential to the success of their organizations. I just want to applaud you for listening. I think that we have done some good work in educating who end-users are and what they need to do.

But, I think there are also some outstanding issues relative to end-users that I just—it may be in the weeds a little bit, but these are the issues that, Mr. Chairman, we hear about. I want to discuss for a minute the 1.35 recordkeeping rule. You know, I have heard from folks back home that the requirement for maintaining records for all pre-trade communications, including iMessages and instant messages, can be burdensome for the brokers and may lead to end-users not being able to communicate easily with their brokers, even in immaterial communications.

I know the Commission is in the process of finalizing some relief on this requirement for end-users. Can you discuss what you plan to include in the rule and what communications industry will be required to keep.

Mr. MASSAD. Certainly, Senator. Thank you for the question. What I tried to do shortly after taking office was the Commission had issued some relief here through no action and I said, we need to formalize that. Let us make it a rule. Basically, we had proposed a rule that was consistent with the "no action" relief, but then we invited comment on that rule. The proposal exempts people from keeping, like, these text messages and it reduces the burden on how records should be kept. But, we also invited comments on other aspects of the rule and we did get a lot of comments and we are thinking about that.

I am particularly concerned about the issues you have raised with respect to small participants in this market. We need to make sure small participants in this market who do not necessarily have the systems in place all the time to easily keep a lot of records, we need to make sure they are not overly burdened. So, we are thinking about all those issues. Again, this is one of those where I want to take the time to make sure we get it right.

Senator HEITKAMP. Right. I could not agree with you more, but to appreciate and understand that that communication is a critical part of truly understanding the transaction and we cannot in any way create a system where we would limit the ability to have communication.

With that said, I think one of the great concerns that the American public has with the whole system of what happened in 2008 and what has happened in the past is that all of the bad actors who went to the market who do things that they ought not to be doing do not ever seem to be prosecuted, do not ever seem to find their way into a criminal court. We see civil fines, but we do not see a lot of criminal activity.

I recognize that the recordkeeping is essential to those prosecutions, and so I am wondering if you could discuss how the regulation has or has not been helpful in terms of creating cases and moving towards prosecution of bad actors.

Mr. MASSAD. Well, certainly in just about any enforcement case, there is an extensive process of looking at records of transactions and records leading to transactions, which is why the rule is written the way it is. I think we have been very determined in our efforts not just to bring the civil actions that we can bring, but also to work with the criminal authorities. On any matter where we think there is a basis for criminal prosecution, we work very closely with Justice as well as with state prosecutors.

Senator HEITKAMP. Just a quick question there. As you are working with the U.S. Attorneys' offices and with the Department of Justice, this is an incredibly complicated area. Do you think a lot of times that the reaction may be, this is way too complicated for us, much less a jury, and how do we overcome that?

Mr. MASSAD. Sure, there is sometimes that issue. These are complicated markets and complicated transactions, and a lot of these investigations, particularly today with the automation in our markets, require huge efforts to analyze data—millions, if not billions, of records, sometimes, of data and reconstructing that. That is a challenge.

Frankly, there again, it is an issue of our own resources. If we can more easily look into these things and do more of the legwork

and thereby assist the criminal authorities, then it is much easier for them to step in.

Senator HEITKAMP. Thank you, Mr. Chairman.

Chairman ROBERTS. Senator Boozman.

Senator BOOZMAN. Thank you.

Mr. Chairman, we had the opportunity to visit before you went on your European trip and you expressed the importance of that. Can you—you alluded to it earlier, and you alluded to the margin methodology problems that we are having, recognizing clearinghouses, all these things which are so important. Can you characterize, were you happy with the trip? Then, also, is there anything that we can do as a committee, either through this committee or Financial Services, whatever, is there anything we can do to help you sort the problems out?

Mr. MASSAD. Thank you for the question. Yes, I was pleased that we are making progress. I think there was a lack of information, a lack of understanding in a lot of these areas, and I testified before a committee of the European Parliament and met with individual members of the European Parliament as well as with the European Commission and really went over a lot of these matters in detail to explain why their assumption that differences in our two systems somehow meant that ours was riskier was dead wrong. In fact, if anything, I think ours is superior. But, the issue is just getting to equivalence.

So, I think we narrowed the issues. I think we came up with an understanding on what we are going to do next. Let me see how that goes and then I would be happy to get back to you on whether Congress needs to do something. But, I really appreciate the support of this committee in making sure that we can achieve some of these cross-border issues, harmonization issues, in a way that still ensures American firms are competitive and customers are protected.

Senator BOOZMAN. As a member of the Financial Stability Oversight Council, can you talk a little bit about what you are trying to do to ensure that any new regulatory proposals take into account the potential impact of new regulations on liquidity in the marketplace?

Mr. MASSAD. Sure. Well, I think the Chairman raised the issue on the supplemental leverage ratio. That is not a—well, it is a relatively new regulation, but that is one where, I think, the FSOC is helpful because it establishes the relationships among the regulators. Right now, I am—we are discussing that issue with the OCC, the FDIC, and the Fed, again, because they have very legitimate goals that they are trying to achieve through the SLR. I appreciate and support those goals. But, we also have to make sure that when it comes to this cash margin, for example, that we are appropriately dealing with that so that we also achieve the goal of encouraging clearing. So, that is an example, I think.

Senator BOOZMAN. Very good.

Since Dodd-Frank, we have seen significant consolidation of futures commission merchants, and today, we have about half the number of FCMs serving farmers, ranchers, and other end-users as compared to just a few years ago. What is the impact of fewer FCMs on liquidity in the marketplace for end-users, and do you be-

lieve that the consolidation that we have seen since Dodd-Frank has contributed to less liquidity in the marketplace for end-users?

Mr. MASSAD. Thank you for the question, Senator. I am very concerned about this and actually asked my staff fairly recently to really do a deep dive and look at this. The downward trend in number of FCMs actually began well before Dodd-Frank. You can see it very clearly from 2005 on. But, at the same time, what was curious was the volume in our markets increased, and even the amount of customer funds was increasing. So, we had the number of FCMs going down, but the volume going up. So, we looked at that and realized that a lot of the decline in the number of firms was firms who were not even taking customer money.

Now, there is still an issue here, I think, that we need to look at. We need to make sure that we are not ending up with too few firms. The concentration level of firms was high back then, meaning the number of firms that hold most of the customer margin. It was pretty high before. It is pretty high now. That has not really changed all that dramatically. But, we are still looking at this. I want to make sure, for example, that, again, smaller customers are still able to access these markets, it is not just the larger users.

So, I think we need to do more work on it to really understand this. I think it is not just, though—I mean, there are a number of factors that affect this. The low interest rate environment affects this, you know. It affects the profitability of being in this business. So, there are a number of factors, but I would be happy to come back and visit with you after we have done some more study.

Senator BOOZMAN. Good. Thank you, Mr. Chairman.

Chairman ROBERTS. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Chairman Massad, nice to see you. Thank you for being here. As we have discussed, my interest in banks' involvement and physical commodities, I would like to say a couple of things about that then ask you a question about something else.

In March, Mr. McGonagle sent a letter to the London Metals Exchange, as scrutinizing its application as a foreign board of trade in the operation of the aluminum warehouses. This is a positive development in your agency's oversight of the physical market. I appreciate your responsiveness and I hope that it continues, so thank you for that.

I want to talk about something that you had discussed earlier. Your testimony set out the CFTC's work to address the needs of commercial end-users. Using both new rules and administrative actions, it seems the CFTC has been able to respond where necessary and in a targeted way. Discuss the importance of letting CFTC address the more detailed regulatory issues, if you would.

Mr. MASSAD. It is extremely important, Senator. I think it would be a mistake to try to legislate a lot of these things, to get into this level of detail, and the risks are the following. First of all, markets change. Markets evolve. Market conditions change and needs change. If you try to codify certain things into the law, then markets will react to that and they will change. You will not have the flexibility to respond quickly.

The second thing is, typically, when you try to codify some of these things, you do not do it with quite the same nuance that we

might be able to do in a rule, and so you can very easily create unintended consequences and unintended loopholes.

So, I think, in most of these areas, it is much better to let us try to address it through the rulemaking process or through other forms of administrative action. I welcome the input of this committee in terms of concerns that you want us to look at, but I would hope that we could continue to do it through the regulatory process.

Senator BROWN. Thank you for that. You know, it has become a talking point every time there is any significant problem, whether it is a safety issue on a train or whether it is an economic implosion or almost an implosion of our economy, half a decade ago. The talking point is, we had an economic disaster and government overreached in a dramatic or heavy-handed way. That is sort of the talking point always. Problem here, the government overreached, we have got to find a way back.

I think you have answered that question well, that you need—you obviously need nuance, you need to take steps that are prudent as you move on these things. Congress, particularly this Congress, would like to take some of these rules with a meat axe and write legislation to go in directions we probably do not want to go in, particularly with no nuance to it at all.

Mr. Cota, who is testifying later, mentioned in his written testimony—in the next panel—the risks of creating new legislative loopholes or regulatory exclusions. Do you—talk—I know the answer is yes, so I will not make it that easy a question, do you agree with that. But, give us a couple of examples and be a little more precise, if you can—

Mr. MASSAD. Sure.

Senator BROWN. —on how that can be too far.

Mr. MASSAD. I would be happy to. Well, let us take looking at, for example, the balance between the reporting that we would like to have on the swaps market and participants' ability to hedge. One of the things we did administratively was we provided an exception to some of the reporting requirements in the case of a very illiquid market where a participant in that market came to us and said, if I have to report immediately, that will identify who I am in this market and make it harder for us to hedge. We looked at the facts, we looked at that particular market—it was a very, very narrow market, one kind of, I mean, particular tenor in terms of the time period that they were seeking to hedge, and we agreed with the concern and we addressed it.

Now, if, for example, you say, well, you should have a rule on illiquid markets—you should define what an illiquid market is and you should define what the exception should be—that is just not a very pragmatic way to go, because the definition of what is illiquid is going to vary across the board in all these markets. It is going to change over time. You know, if more market participants start to come into a market for various reasons, well, it becomes less illiquid, and so then you do not need the exception. But, if you try to legislate something like that, you are going to create all sorts of issues and inconsistencies.

Senator BROWN. Thank you, Mr. Chairman, and Mr. Chairman, thank you.

Chairman ROBERTS. The Chair is delighted to recognize the Senator from South Dakota, Senator Thune, but only remind him that he has an hour before his high noon.

[Laughter.]

Senator THUNE. Thank you, Mr. Chairman. I am delighted to be recognized by the Chairman, and I want to thank you for holding this hearing on regulatory issues impacting end-users.

I think it is fair to say in agriculture today that the margins are slim to nonexistent, and that is not true just for farmers and ranchers, that is true for elevator operators and suppliers, and a critical component of any agricultural operation is risk management. But, we have got an awful lot of burdensome reporting requirements, unnecessary over-regulation, particularly in certain areas of Dodd-Frank implementation, and so there are folks who spend way too much time focusing on regulatory requirements and recordkeeping and not enough time on effective risk management. I hope that as we work through reauthorization this year, that we focus and get answers to questions about CFTC rulemaking over regulation and restrictive measures to end-users and, again, focus specifically on Dodd-Frank.

Mr. Massad, throughout the development of Dodd-Frank, there were a number of Senators on this committee who expressed concern about global regulatory confusion ensuing if regulations were not well coordinated, and I think due to the number of regulations, the number of regulators around the world necessary to put into effect national implementation of these complex derivative provisions, these warnings now seem to be realized. In spite of assurances that global regulators were united, it has become obvious that these regulatory relationships are strained.

CFTC was a first mover in many of these—many of their regulations, and in particular with regard to cross-border application of your regulations, the CFTC issued guidance rather than formal rulemaking. Why is that?

Mr. MASSAD. Well, I was not at the Commission at the time, Senator, so——

Senator THUNE. I know you were not.

Mr. MASSAD. —I do not know that I can go to how people made that decision. What I can tell you is that we are very focused on harmonizing the rules. I would note, also, that Congress did mandate that the rules be done in a year, basically, which did put the agency under tremendous pressure, and I think it is a credit to the staff of the agency that they worked hard to get the rules done.

The issue of cross-border harmonization, I think, we need to put in perspective. Each—while the G–20 nations agreed to the basic principles they wanted to implement, it still falls to individual nations to do it. None of us—none of those nations are willing, for example, to delegate their authority. I am sure this Congress is not willing to delegate its authority, or our authority, to the Financial Stability Board or anyone else. It is our job to do it for our country. It is the European Parliament and the European Commission's job to do it for Europe. Japan has to do it for Japan, and so on and so forth.

Having said that, there has been tremendous progress, and I am happy to go through each of the areas where there has been

progress, and a lot of it—most of it has come from us. We have made, for example, substituted compliance determinations in a whole host of areas for several jurisdictions. Now, other jurisdictions have not because they have not gotten their rules done, in many cases.

We are working very hard on this issue of clearinghouse recognition. It has been difficult. I could have agreed to it a year ago had I been willing to have our clearinghouses impose higher costs on the very people you are concerned about. So, that is why it has taken time. It has taken time to work through some of these issues. We did not want to impose higher margin costs on our participants——

Senator THUNE. Well, the—I am sorry. The SEC took a different approach, though, and has now twice proposed formal rules to address the global reach of their derivatives regulations. So, has the CFTC's move to address cross-border matters through more expedient guidance really, in your judgment, resulted in advancing the goals of more transparency and better risk management, or has it created more of a regulatory impasse?

Mr. MASSAD. Well, again, the guidance was done a while back. I can tell you what we are doing today. We are doing it through rules. For example, in the case of margin for uncleared swaps, we put out for public comment a proposal, and we are going to have a roundtable about this this afternoon and inviting public participation on this, as to what our approach should be in terms of the cross-border application of the rule on margin for uncleared swaps. We noted, for example, that there is an approach based on the guidance, but that may not necessarily be the right approach. So——

Senator THUNE. Did you—will your agency consider, though, or contemplate formal rulemaking to better——

Mr. MASSAD. We are doing it.

Senator THUNE. —global coordination?

Mr. MASSAD. We are doing it already. We are doing it in the area of margins. We are doing it in the area of reporting. So, we are doing it in a number of areas, and we are aware of what the SEC is doing. We are looking at what they are doing and working with them.

Senator THUNE. All right. My time has expired. Thank you, Mr. Chairman.

Chairman ROBERTS. Senator Casey.

Senator CASEY. Thanks very much, Mr. Chairman. We are grateful you are here and thanks for your service. Difficult subject matter and a difficult time to serve.

I wanted to ask you about these affiliates of the so-called centralized treasury units in terms—really, a two-part question, and that is really all I have for today. The relief that has been granted, can you walk through how that process works? That is kind of question number one. Then, number two, is it having the intended effect, or can you assess the effect it is having?

Mr. MASSAD. Thank you, Senator. I think it is. What we did was we made it clear that, for example, commercial end-users are entitled to exemptions from the clearing mandate, from the trading mandate, but a lot of companies, especially large companies, will do

their financial transactions, including their swaps, through what we refer to as a treasury affiliate. It is essentially a special purpose subsidiary that only engages in financial transactions. Because it only engages in financial transactions, there was a risk that it could be viewed as a financial entity rather than as part of an end-user. So, we made that clear.

We are continuing to look at this issue. There was an issue that came up that one of the auto companies asked us about for clarification on a related point. We issued that clarification about a week or two ago. We are looking at the issue, also, in terms of the rule on margin for uncleared swaps, which exempts commercial end-users, and we will, again, make sure that works from the standpoint of how large companies today organize their operations.

So, I think we are very focused on this. There is often a lot of nuance and detail to it, and that is why, again, I think it is best to do it through the regulatory process.

Senator CASEY. So, I guess the assessment you—I do not want to put words in your mouth, but these are challenging, but you have been able to manage——

Mr. MASSAD. Absolutely. Yes, sir.

Senator CASEY. Thank you very much.

Mr. Chairman, I am giving back two minutes and 49 seconds.

[Laughter.]

Chairman ROBERTS. We will bank that for you, Senator Casey.

Senator STABENOW. We will bank that, yes.

Chairman ROBERTS. Senator Klobuchar.

Senator KLOBUCHAR. Thank you, Mr. Chairman. I thought Senator Casey was giving it to me, but that is okay.

[Laughter.]

Senator KLOBUCHAR. Thank you so much, Mr. Chairman, for being here, and thank you to our Chairman and Ranking Member for holding this hearing.

As Chairman Massad, for a long time, years before you had this job, I have worked with the CFTC on the issue of position limits, on oil speculations, and I look forward to continuing that work. I also have been focused on the issue which I know the Chairman asked about of the end-users and this differentiation between people who are in the financial sector and then people who actually are end-users, like farmers and rural energy co-ops, manufacturers, and people who are doing things like buying oil at a certain price, or farmers who are buying other products at a certain price. So, those have been my major focuses and I am glad we were able to get this end-user issue resolved at the end of the year.

I think my first question would be about how in your testimony you stress the importance of all the actions that have been taken to make the market safer since 2008, you have greater ability now at the CFTC to regulate swaps in the derivatives market. From your perspective, 11 months on the job, what are the biggest challenges you face?

Mr. MASSAD. Well, the biggest challenge is resources. There is a lot more we should be doing. There is a lot more areas where we simply cannot get to because of the resources. We cannot respond to market participants as quickly as we would like. We cannot address a lot of their concerns. We cannot engage in the oversight of

some of the large clearinghouses. We cannot do examinations as frequently. We do not have enough resources to look at cybersecurity, which is perhaps the biggest single challenge for us today.

Senator KLOBUCHAR. Have any of my colleagues asked you about the cybersecurity issue.

Mr. MASSAD. No.

Senator KLOBUCHAR. Okay. Well, when we talk about those resources, and I am sure you are concerned about budget proposals that would erode your resources even more——

Mr. MASSAD. Mm-hmm.

Senator KLOBUCHAR. —okay, and is the budget that has been proposed in the Senate, does that make cuts to the CFTC?

Mr. MASSAD. I do not know that I have seen a number yet for us.

Senator KLOBUCHAR. Okay. All right. Well, we should look at that.

On the cybersecurity side, it has, unfortunately, as we know, been routine to see companies victims of cybersecurity, and thus their customers, whether it is Sony, whether it is Home Depot, whether it is what we saw in Minnesota with Target, do you think that the exchanges and clearinghouses are putting enough emphasis on data security as part of their business plans, or are they just waiting for something to happen, and what are the disclosure requirements for the exchanges and clearinghouses in the event of a cyber-attack? What I am really getting at is how and when will people know when there has been a breach?

Mr. MASSAD. Well, I guess I would answer it this way. I would say, first of all, the exchanges and the clearinghouses are taking this very seriously. I know you are going to have Terry Duffy shortly, and he and I have had a number of conversations about this. But, this is a huge concern for everyone today, not just financial companies, but all sorts of companies. There is a lot of work going on.

But, we are looking at, is that enough, how can we add value here to this process, and one of the things we are looking at, for example, is we do not have the resources to do testing ourselves, but we want to make sure that clearinghouses and exchanges are doing enough testing on their own, whether it is what we call control testing, vulnerability testing, or penetration testing, where you really have someone who tries to hack your system and you push it until the point where you succeed in hacking so you can figure out where the vulnerabilities are.

So, that is one of the things we are looking at, whether we can contribute by maybe setting standards of best practices that firms should follow when they do their testing.

Senator KLOBUCHAR. Yes.

Mr. MASSAD. We are also working with other governmental agencies here. This is obviously not something that we can do on our own. We work with DHS and the FBI and the other financial regulators on that.

Senator KLOBUCHAR. Okay. Could I just ask you one more question about something I raised at the beginning, and that is speculative trading's effect on the commodities market, notably gas, oil, wheat in the past. Last time we were here, we talked about how

Parnon Energy and Arcadia manipulated the crude oil market and now the CFTC has just filed an enforcement action against Kraft and its parent company for manipulation of the cash wheat and wheat futures market. I am also concerned that end-users like our small farmers and rural energy co-ops might not be able to conduct their business because of some of the rules which are well intended, of course.

So, what is happening with all of that? I know you have looked extensively at the speculation issue and how can these rules best work for everyone.

Mr. MASSAD. Well, thank you for the question. Obviously, I do not want to comment on particular enforcement proceedings, but let me just comment generally.

You know, I think, again, this comes back to resources, quite frankly, because these markets have changed. They have become far more electronic, far more automated. The days when we could watch trading pits and see if someone pulled an earlobe or something to determine whether there was manipulation are long gone. Now, today, we have to look at reams and reams of records—I mean, we are talking about billions of records here for a particular case, sometimes—to reconstruct trading patterns and to determine if there is a problem. We work, again, very closely with the exchanges. They are the front line of defense on these things. They have increased their resources in terms of monitoring trading behavior. So, we work very closely with them, also.

But, what is needed here more than anything else is the resources so that we can invest in the information technology systems. Senator Stabenow referred to we cannot even keep up with the markets, much less get ahead.

Senator KLOBUCHAR. Thank you very much. I appreciate it.

Thank you, Mr. Chairman.

[Pause.]

Chairman ROBERTS. I would like to yield at this point and recognize Senator Boozman for one additional question.

Senator BOOZMAN. I was just curious, Mr. Chairman, you mentioned that you had fined $2.5 billion or whatever. How much do we actually collect of that?

Mr. MASSAD. I can check on that. I think we collected 2.3 of that.

Senator BOOZMAN. Okay. So, the collection rate——

Mr. MASSAD. On that.

Senator BOOZMAN. —under your regime is——

Mr. MASSAD. Yes. Now——

Senator BOOZMAN. —is pretty robust, or——

Mr. MASSAD. Well, to be perfectly thorough on this, when you have settlements and fines against institutions, larger institutions, you typically collect more, or you collect it. We have a lot of cases—we have a lot of small cases, Ponzi schemes, precious metal frauds. A lot of these operators go out of business before we can catch them sometimes, or before we can reach the judgment or the settlement. It is much harder there to collect.

Senator BOOZMAN. I guess if we are going to use that as a measure of success, then we do need to go further and actually talk about that perhaps a little bit more.

Thank you, Mr. Chairman.

Mr. MASSAD. I am happy to give you all those statistics.

Chairman ROBERTS. Thank you, Senator.

Mr. Chairman, before you go, we are tasked with reauthorizing the CFTC—that is why we are holding this hearing—as is the House of Representatives. We want to work with you in a very bipartisan way and with the Commission's help. So, my question is, will you commit to working with us, along with your staff and other Commissioners, in a productive fashion?

Mr. MASSAD. Absolutely, Senator.

Chairman ROBERTS. Great. Thank you so much.

Mr. MASSAD. Whatever you need.

Chairman ROBERTS. The distinguished Senator from Iowa has arrived and I would be happy to recognize him at this point. Senator Grassley.

Senator GRASSLEY. You know, oversight is a big part of my work and I wanted to say that Senator Johnson and I have raised concerns about CFTC's decision to charge the Inspector General's Office $331,000 to cover overhead. I question whether the CFTC Chairman may determine if and to what extent funds may be removed from the IG's appropriation for any purpose that would amount to nearly 13 percent of their budget, funds that could otherwise pay for additional staff salary.

During an April 17, 2015 phone call between our offices and the CFTC staff, we requested documents to help us better understand overhead charges for that office and specifically requested the amounts of overhead charged the IG in the past, the CFTC OIG budget request for fiscal year 2015, and the request submitted to OMB for fiscal year 2015 in the amount of overhead charges per office. We have not yet received those documents, so I would like your assistance that this information will be made available to Senator Johnson and me within a week. Is that possible?

Mr. MASSAD. I see no reason why we cannot do that, Senator.

Senator GRASSLEY. Thank you, Mr. Chairman.

Mr. MASSAD. Can I just——

Senator GRASSLEY. Yes.

Mr. MASSAD. —if I may, though, just say a word or two about it.

Senator GRASSLEY. Of course, you can.

Mr. MASSAD. My understanding of what we do here is that the IG gives us a budget and we then add an amount for overhead and then that sum is what we submit as the budget request. In fact, the IG was given even more than the sum of what the IG requested and what that overhead charge is.

I would also point out that the overhead charge is a very simple calculation. It does not even—it is not even fully loaded. All it is, is a percentage, a fraction, if you will, of our leasing and certain other kind of overhead charges that is based on number of FTEs. But, we do not charge the—we do not even charge the IG for information technology or any of our—a lot of our other services.

Senator GRASSLEY. Well, I appreciate your explanation, and if you give us these documents, then we will be able to satisfy ourselves.

Mr. MASSAD. Certainly.

Senator GRASSLEY. Thank you very much.

Thank you, Mr. Chairman.

Chairman ROBERTS. Okay, and thank you, Mr. Chairman.

I would like to welcome our second panel of witnesses before the committee.

First, we have Mr. Terry Duffy, Executive Chairman and President of the CME Group. Mr. Duffy joins us from Chicago, where he is the Executive Chairman and President of the CME Group. Mr. Duffy has served in his role as President since 2012 and has been the Executive Chairman since 2006, when he became an officer of the company. Terry, thank you for being here today and I look forward to your testimony.

Mr. Bruce Barber is the General Manager of Oilseed Risk Management, Archer Daniels Midland Company in Forsyth, Illinois, testifying on behalf of the Commodity Markets Council, CMC. Mr. Barber also comes from Illinois, is the General Manager of Oilseed Risk Management for the Archer Daniels Midland Company. He has been in the grain business for many years and is here today on behalf of the Commodity Markets Council. This is Mr. Barber's last official act, as he will be wrapping up a 33-year career with ADM at the end of this month. Bruce grew up on an Iowa farm. He graduated from Iowa State. Nothing wrong with that.

[Laughter.]

Chairman ROBERTS. I am just remembering all those last-minute basketball games where they defeated K–State, but at any rate——

[Laughter.]

Chairman ROBERTS. He grew up on an Iowa farm, graduated from Iowa State, and has traded wheat, corn, soybeans, soybean meal, soybean oil from locations all over the Midwest. He has spent the last two years trading for ADM in Geneva, Switzerland. Bruce Barber, congratulations and welcome home.

Mr. BARBER. Thank you, Mr. Chairman. It is good to be home.

Chairman ROBERTS. We have Mr. Jeff Walker, Senior Vice President and Chief Risk Officer, Alliance for Cooperative Energy Services from Carmel, Indiana. Mr. Walker is joining us from Carmel, where he serves as Senior Vice President and Chief Risk Officer for the Alliance for Cooperative Energy Services. Mr. Walker leads ACES's Energy Risk Services, including trading, control, credit, contract administration, and regulatory and corporate development. Thank you for making the trip, sir. We look forward to hearing your testimony.

Mr. Michael Bopp, Partner at Gibson, Dunn and Crutcher, LLP, Washington, DC, testifying on behalf of the Coalition for Derivatives End-Users. Mr. Bopp is a partner at Gibson, Dunn and Crutcher here in Washington. He represents the Coalition for Derivatives End-Users. The Coalition represents the views of more than 270 end-user companies that employ derivatives primarily to manage risk associated with their businesses. Thank you, sir, for being here today, and we look forward to your participation.

We have Mr. Sean Cota, the co-founder of Commodity Markets Oversight Coalition, Bellows Falls in Vermont. Mr. Cota is the co-founder of the Commodity Markets Oversight Coalition, which represents the commodity-dependent businesses in the transportation, energy, and agriculture sectors. He has nearly four decades of experience in the downstream petroleum industry, including more than

17 years as president of his family's successful heat, oil, propane, and motor fuels company in Vermont, and we look forward to your testimony.

We will start it off with Mr. Duffy.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, ILLINOIS

Mr. DUFFY. Chairman Roberts, Ranking Member Stabenow, thank you for having me today. As the Chairman said, I am Terry Duffy, the Executive Chairman and President of the CME Group, and I appreciate the opportunity to offer our views on the CFTC reauthorization.

It is critically important to structure regulation to protect the integrity of our markets. They need to be available to meet the hedging and risk transferring needs of end-users. These include producers and consumers of agriculture and energy products, as well as businesses facing interest rate, equity, and currency risks.

The CFTC, under the leadership of Chairman Massad, has appropriately reformed several regulations that needlessly limited end-user risk management on regulated markets. We applaud these recent actions. They will reduce the burdens associated with excessive residual interest charges that we have discussed before at this committee and redundant trade reporting and recordkeeping. This is a good start, but other problematic proposals offered after Dodd-Frank need to be reexamined.

For example, we endorse the end-users' call for more flexible hedging treatment, especially, as the Chairman mentioned earlier, anticipatory needs of hedging. We also urge the CFTC to continue the practice of permitting exchanges to administer hedge exemptions consistent with the needs of end-users.

We also support setting limits based on current deliverable supply data. The use of current data will ensure an accurate depiction of what the actual deliverable supply is. It also eliminates the basis for unfounded claims that financially settled look-alike contracts should be given five times higher limits than underlying physically settled contracts. Different limits for equivalent contracts distort transaction flow and the settlement process.

Another topic that will impact the end-users is that European regulators refuse to recognize that U.S. regulation is equivalent to that of the European Union regime. Under European law, U.S. clearinghouses and exchanges like CME must be recognized by the European regulators. This recognition can only happen if the European Commission first determines that the regulations in the United States are equivalent to European Union regulations. Without recognition, European clearing firms and market participants will be subject to prohibitive costs if they clear or trade in the U.S., or they may be denied access to U.S. clearinghouses and exchanges altogether.

Chairman Massad has been a strong leader in his negotiations with his European counterparts. He testified, as he said earlier, effectively before the European Parliament just last week. I hope he will be successful in reaching an agreement that will allow U.S. markets to be recognized by the European Union the way they par-

ticipate in ours without compromising the robust risk protections of the United States regulatory regime.

Another concern that will add additional harm to end-users is the supplemental leverage ratio rule imposed under the Basel III by European central bankers and by our own U.S. Federal Reserve. This rule will permit bank regulators to impose punitive capital charges on clearing firms that support activities of end-users. This rule imposes unwarranted capital charges that do not recognize the netting and bankruptcy remoteness offered by clearing. It will make it difficult or impossible for small end-users to find a clearing member firm so they can continue to facilitate their risk management needs.

I want to thank you, Mr. Chairman, Ranking Member Stabenow, for the opportunity, and I look forward to answering your questions.

[The prepared statement of Mr. Duffy can be found on page 67 in the appendix.]

Chairman ROBERTS. We thank you.

Mr. Barber.

STATEMENT OF BRUCE BARBER, GENERAL MANAGER, OILSEED RISK MANAGEMENT, ARCHER DANIELS MIDLAND CO., FORSYTH, ILLINOIS, ON BEHALF OF THE COMMODITY MARKETS COUNCIL

Mr. BARBER. Chairman Roberts, Ranking Member Stabenow, and members of the committee, thank you for the opportunity to testify on behalf of the Commodity Markets Council to discuss the regulatory burdens impacting end-users and market liquidity as they relate to reauthorization of the CFTC.

I am Bruce Barber of Archer Daniels Midland. For more than a century, the people of ADM have transformed crops into products that serve the vital needs of a growing world. Today, we are one of the world's largest agricultural processors and food ingredient providers, with more than 33,000 employees serving customers in more than 140 countries.

As Congress seeks to once again reauthorize the CFTC, hedgers of agricultural commodities and energy products are being asked if we are better off in today's regulatory environment compared to the days before Dodd-Frank. The direct answer is no. I would point out that during the financial crisis, no exchange, DCM, clearinghouse, or commodity end-user of derivatives was bailed out with taxpayer money.

Despite our best efforts, what I can tell you is that our compliance costs are up substantially. The compliance expenditures for ADM Investor Services, ADM's FCM, have doubled in the past five years.

Chairman Massad has an understanding of our concerns and CMC is appreciative of the Commission's improved and appropriate emphasis on end-user issues during his tenure. This recognition indicates that some of these rules have not been well crafted and have the potential to do harm, particularly to end-users. Many CMC members would describe this situation as an example of process failure. During this reauthorization process, we would ask this committee to focus its efforts on the contrast between the Congres-

sional intent of Dodd-Frank's Title VII versus today's reality of how it is being implemented in an effort to address this process failure.

A multitude of new CFTC rules have burdened end-users and commercial participants with additional regulatory costs. These will ultimately be passed on to producers and consumers as they work their way through the supply chain. There will also be an impact on market liquidity, which will further raise the cost of risk management and, ultimately, the cost of finished agriculture and energy goods. In other words, if Dodd-Frank is not implemented as Congress intended, this law will hurt the people that it was intended to help.

Since President Obama signed Dodd-Frank, the Commission has issued 274 "no action" letters, 20 interpretative letters, and 64 exemptive letters, all providing different levels of regulatory relief to CFTC rules. This compares to 201 "no action" letters during the decade prior to Dodd-Frank.

As Congress moves to reauthorize the CFTC, the CMC urges this committee to address the concerns of end-users, which are more fully described in my written testimony. In brief, the five key issues are: Reporting requirements set out in Rule 1.35; updating deliverable supply estimates that will serve as the baseline for position limits determinations; getting the bona fide hedging definition right so that it recognizes all the myriad types of risk that end-users must hedge; the automatic drop in swap deal de minimis threshold; resolution of international regulatory issues, including U.S.-E.U. equivalence and the Basel III supplemental leverage ratio.

To conclude, the swaps market reforms in Dodd-Frank were not required because of problems in physical commodity markets. Commercial end-users of agriculture and energy futures had no role in creating the financial crisis. Today, agriculture and energy end-users are faced with thousands of pages of new CFTC rules, followed by a multitude of letters issued by the Commission to clarify rule language, extend compliance dates, and provide temporary "no action" relief.

The problem is not just that complexity and regulatory uncertainty adds unnecessary costs, it is that uncertainty via additional regulation of the risk management tools that commodity market participants utilize actually creates risk where it did not previously exist. CMC members mitigate risks by hedging. The fact that future regulation may determine that the risk management methods we have cited here today may no longer be considered hedging is of enormous concern and is an example of where risk could be created.

When regulatory initiatives lack clarity or evolve to be at cross-purposes with the core principles on which the Commission was founded, CMC members are compelled to reach out to this committee for help.

Thank you for this opportunity to testify. We look forward to continuing to work with the committee to strike the right balance. I look forward to your questions.

[The prepared statement of Mr. Barber can be found on page 40 in the appendix.]

Chairman ROBERTS. Mr. Barber, thank you very much for an excellent statement.

Mr. Walker.

STATEMENT OF JEFFREY L. WALKER, SENIOR VICE PRESIDENT AND CHIEF RISK OFFICER, ALLIANCE FOR COOPERATIVE ENERGY SERVICES, CARMEL, INDIANA

Mr. WALKER. Chairman Roberts, Ranking Member Stabenow, thank you for inviting me to testify today on the regulatory burdens impacting end-users and market liquidity. I am Jeff Walker, the Chief Risk Officer for Alliance for Cooperative Energy Services, or ACES for short.

ACES is owned by 21 not-for-profit electric cooperative power supply members who use ACES' commodity service to participate in the wholesale energy markets. Not only are ACES' member-owners commercial end-users, but they are also ultimately owned by the retail electric consumers they serve in 27 states, including Arkansas, Colorado, Georgia, Indiana, Iowa, Kansas, Kentucky, Minnesota, Mississippi, North Carolina, and Ohio. ACES is headquartered in Carmel, Indiana, and has office operations in Minnesota, North Carolina, and Arizona.

U.S. consumers expect some volatility in the price of gasoline they pay at their local gas pumps from week to week, but when consumers get their monthly electric bill, they have always expected more price stability. Sometimes we can use physical transactions to lock in energy prices. However, financial transactions must also be used, when appropriate, to lock in prices to manage the volatility of the commodities our members use to produce and serve electricity to consumers.

Since 2010, the Dodd-Frank Wall Street Reform Act and dozens of new CFTC regulations and interpretations have impacted our energy commodity transactions by adding significant regulatory burden on energy market end-users doing business on Main Street, not Wall Street. I will take a moment to highlight some of the challenges our electric cooperatives have faced under Dodd-Frank.

In 2010, CFTC stated in a rulemaking that it would not provide a bright line test for compliance with its Dodd-Frank regulations because of concerns that doing so would provide a road map for evasion to market participants. However, this same approach has resulted in regulations that are vague and ambiguous, making understanding such regulations costly and compliance by end-users confusing, time consuming, challenging, and very expensive.

Second, in 2012, CFTC imposed an entirely new set of obligations requiring end-users to keep records of pre-trade written communications. Prior to Dodd-Frank, only fiduciaries serving market customers and holding customer funds were burdened this way. Today, end-users subject to Regulation 1.35 get saddled with much more onerous and non-standard record retention periods, not only for pre-trade communications and financial derivative records, but also for all of their related physical commodity commercial activity. Even worse, this onerous burden may be overlaid on the entire business dealings of an end-user's jurisdictional activities, even aside from the direct access trading venue that caused them to be subject to Regulation 1.35.

Third, Dodd-Frank has brought about an overlap of dual regulation by two federal agencies, the Federal Energy Regulatory Commission and the CFTC, of certain physical commodity transactions, namely options that, when exercised, are fulfilled by one party delivering a physical commodity to the other party. Furthermore, it is commonplace in the energy markets to have transactions that combine both jurisdictional and non-jurisdictional attributes together. For example, fixed volume forward contracts will often include a layer of volume flexibility called embedded optionality in order to enable an end-user to balance non-storable supply with variable demand in real time.

In 2012, CFTC adopted a complex set of interpretations to determine whether or not hybrid transactions are jurisdictional swaps, in the form of a seven-part test. So, if you can thread all seven needles with a single strand, your hybrid transaction is not a swap, but that seventh needle can be a show stopper.

Finally, CFTC's 2013 proposed rule for speculative position limits places more unnecessary burdens on end-users of physical energy commodities and related swaps. Very narrow bona fide hedge exemptions to position limits are proposed by CFTC. End-users were told they can only hedge their commercial risk using hedges that are also bona fide for traders. They are also viewed as potential market speculators and having to monitor their positions on a daily and intra-day basis, provide precise plans and ten-day notices before hedge exemptions can be deployed, and submit reports to CFTC daily and monthly when they are deployed.

Moving forward, we would like Congress and the CFTC to address the challenges discussed in this testimony, whether legislatively or administratively, to ensure that end-users are not treated like they were the cause of the 2008 financial crisis. We look forward to providing any information that would be helpful to the committee as it addresses CFTC reauthorization. We are supportive of reauthorization, but must respectfully request that the CFTC narrow the scope of its rules to remove the significant and unnecessary burdens on end-users.

Thank you for the opportunity to testify. I would be happy to answer any questions you may have.

[The prepared statement of Mr. Walker can be found on page 95 in the appendix.]

Chairman ROBERTS. Thank you, Mr. Walker.

Mr. Bopp.

STATEMENT OF MICHAEL D. BOPP, PARTNER, GIBSON, DUNN AND CRUTCHER, LLP, WASHINGTON, DC, ON BEHALF OF THE COALITION FOR DERIVATIVES END-USERS

Mr. BOPP. Chairman Roberts, Ranking Member Stabenow, other members of the committee, I am Michael Bopp, a partner at the law firm Gibson, Dunn and Crutcher, and counsel to the Coalition for Derivatives End-Users. I want to thank you for inviting the Coalition to be a part of this hearing.

We represent hundreds of end-users from across the economy that employ derivatives to manage everyday business risks and we support regulation that promotes economic stability and transparency without imposing undue burdens. We believe that impos-

ing unnecessary regulation on derivatives end-users who did not contribute to the financial crisis restricts job growth and hampers U.S. competitiveness.

End-users applaud Congress's passage earlier this year of legislation providing them relief from mandatory initial and variation margin requirements and we are grateful to the 17 members of this committee who opposed an amendment that would have stripped the end-user margin bill from the Terrorism Risk Insurance Act legislation to which it was attached.

The Coalition also appreciates and supports the Chairman's introduction of the centralized treasury unit, or CTU, bill, S. 876, which would prevent end-user companies from being denied use of the end-user clearing exception in Dodd-Frank drafted specifically for them. We thank Senators Collins and Klobuchar for introducing the same bill last Congress.

Today, the Coalition would like to focus on three areas where we believe Congressional attention would help address inefficiencies and unnecessary expense.

One issue is capital and liquidity requirements. Excessive capital requirements, including the net stable funding ratio and other outstanding Basel capital reforms, threaten to eviscerate the benefits of the margin legislation that was passed in January. As the cost of those capital requirements is passed on from banks to end-users, end-users are faced with a decision of whether to forego risk mitigation altogether, to enter into an imperfect hedge, or to pay substantially increased hedging costs. With every choice, the end-user faces the possibility of being competitively disadvantaged against foreign competitors.

Another issue is cross-border market fragmentation. International harmonization is of great and growing importance and is particularly relevant for derivatives end-users. For the many that have affiliates located around the world and subject to multiple regulatory regimes, inconsistencies lead to increased costs, confusion, duplication, and decreased liquidity. A good example of this is a lack of consistent data and reporting standards across jurisdictions. In your oversight of the implementation of the Dodd-Frank Act, we urge you to encourage U.S. regulators to work with foreign regulatory regimes to recognize equivalence between jurisdictions using an outcomes-based analysis and with the interests of end-users in mind.

A third and perhaps most important issue involves our use of centralized treasury units. Many non-financial end-users employ centralized treasury units to reduce risk by having a single entity centralize and net the hedging needs of all of its affiliates. In fact, nearly half of the respondents to a Coalition survey indicated they use CTUs to execute over-the-counter derivatives. Let me take a moment to explain.

Everyone should have a slide titled "Centralized Treasury Units," which I will refer to for illustration. In the hypothetical, ABC Corporation has two affiliates that have hedging needs. Instead of each affiliate going to the market independently to hedge its risk, they trade through ABC Corporation's CTU. The advantages here are many, but I will mention two.

First, reduced market exposure. Because the ABC Corporation affiliates both need to hedge interest rate risk, the CTU is able to net those exposures and make only one trade with a bank counterparty. The alternative would have been for each affiliate to enter its own trade with a bank, thus doubling ABC Corporation's overall exposure to the bank.

Second, economies of scale. ABC Corporation can centralize its derivatives expertise in the CTU instead of spreading it among its affiliates and can enter into just one legal, or ISDA, agreement with the bank counterparty instead of each affiliate entering into its own contract. In our example, there are only two affiliates that have need of reducing risk through hedging, but imagine a company with 200 such affiliates, which is not uncommon. The economies and savings become very substantial.

Why does this matter? Because CTUs are financial entities and the end-user clearing exception only applies to non-financial entities. You might ask, why does Dodd-Frank not look through the CTU to the affiliate to determine whether the clearing exception applies? That is an excellent question. Unfortunately, the answer is, it does not for the type of CTUs end-users tend to employ.

S. 876 simply looks through the CTU to the affiliate whose risk is being hedged, and if the affiliate could hedge its risk and qualify for the end-user clearing exception, then the company will not be denied the exception simply because it uses a CTU. It is a simple, narrowly tailored solution that we urge this committee to approve.

Thank you, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Bopp can be found on page 53 in the appendix.]

Chairman ROBERTS. Well, thank you, Mr. Bopp. I am sorry the Chairman left.

Mr. Cota.

STATEMENT OF SEAN O. COTA, CO–FOUNDER, COMMODITY MARKETS OVERSIGHT COALITION, BELLOWS FALLS, VERMONT

Mr. COTA. Chairman Roberts, Ranking Member Stabenow, members of the committee, the Commodity Markets Oversight Coalition appreciates the opportunity to provide input as you begin work on CFTC reauthorization.

The CMOC is a nonpartisan alliance of thousands of businesses, commodity-dependent businesses that rely on secure, transparent, and accountable futures. Options and swaps markets as a hedging and pricing discovery tool are critical to that. A list of organizations that endorse my testimony can be found in my written statement. I would like to ask that the Owner-Operator Independent Drivers Association and the Industrial Energy Consumers of America be added to that list.

Chairman ROBERTS. Without objection.

Mr. COTA. I have worked decades and 17 years as the president of my family company, which markets home heating oil, motor fuels, and most importantly, biofuels, in greater Vermont. Hedging is a part of that business, of which I was the manager of that hedging and gave me experience over the decades that I participated in

that. It is critical in our business, as a cyclical business that has large variance because of temperature, in how to hedge the various risks that come in with futures contracts.

We encourage the committee to use the reauthorization to strengthen the protection that hedgers have and build upon these key reforms that are in Dodd-Frank. These reforms relative to the volatile conditions and opaque markets that existed prior to Dodd-Frank have increased the confidence in these markets in the commodity dependent businesses that we have.

Over the last five years, volatility has declined considerably for many of the commodities by 40 percent or more. There are three top things that Congress can do to ensure that the CFTC continues to serve and protect small hedgers and commodity dependent businesses.

First and foremost, you should fully fund the CFTC at the $322 million level requested for fiscal year 2016. We have seen in recent years these markets affect the lives of every American. The CFTC has done its best to oversee these markets, given its historically inadequate resources. As you have heard from Chairman Massad, the CFTC's collection of civil penalties has increased over twenty-fold over the last five years. This is many multiples of what their budget is. Going forward, additional funding will be necessary for the CFTC to continue to police and prosecute manipulation, to monitor constantly evolving and ever changing markets. Trading practices change. Technologies change. Threats like cyber-terrorism and cyber-espionage are critical and they need the funding to do that.

Second, Congress should increase the cap on penalties for fraud and manipulation. Individual penalties have become insignificant. They are just a cost of doing business. They need to be, in our opinion, multiples of what the impact of that manipulation was, and that should be introduced.

Third, lawmakers should have the right to reinforce Congressional intent that the end-users not be captured by regulations meant for financial institutions and systematically significant market participants. Our Coalition believes that the CFTC has the authority to address most of those concerns of the commercial end-users and they can do that within the agency. If not, the committee should address those issues in reauthorization. However, a great care should be taken not to inadvertently create new loopholes through additional legislation. Every definition seems to change once it gets into rulemaking. Large institutions and other large market participants are weakening exemptions meant only for bona fide hedgers, and allowing them to trade overseas without oversight is not in our interest.

One final issue that is certain to come up today is the issue of position limits. Congress required the CFTC to impose speculative position limits on all markets in futures and swaps to help minimize swings in the price in commodities, and it is important to prevent manipulation. The CFTC is negotiating the final rule. This is now the fourth stab at it. While some bona fide hedgers have concerns about how to structure these exemptions, nearly all of them are supporters of meaningful limits in these markets. We hope that their ongoing concerns can be adequately addressed and the CFTC can move forward with that final rule. The conditional spot month

is a critical issue in pricing and that concern needs to be addressed in that process.

Thank you again for the opportunity to present before this committee.

[The prepared statement of Mr. Cota can be found on page 58 in the appendix.]

Chairman ROBERTS. Well, thank you, Mr. Cota.

Mr. Walker, elaborate on what you refer to in your written testimony as a, quote, "recordkeeping briar patch"—I will add in the needles, if you wish—that a party may enter into by simply making one transaction. What are some of the costs and burdens associated with the new recordkeeping rules? Mr. Barber, please feel free to chime in here, as well, on this issue that you have highlighted in your testimony. Mr. Walker, Mr. Barber.

Mr. WALKER. Yes. If I can go first, one of the issues we have is much longer retention periods for recordkeeping. The worst case prior to Dodd-Frank was for Federal Energy Regulatory Commission purposes we would keep records five years from record creation. Under Dodd-Frank, physical records would have to be kept for the life of the transaction plus five years. Our physical transactions with optionality that are swaps can be five, ten, 20 years long, so you are talking about life of that transaction plus five years can be ten, 25 years long, quite a long time.

Also, both derivatives and physical transactions are subject to these retention periods. Pre-trade written communications must be kept not only on the derivative transactions, but also the physical transactions that are related to those. We, on behalf of our clients, are avoiding nodal exchange because of the impact of 1.35. That means that we are not hedging. We are more exposed. It also reduces market liquidity on nodal exchange because of that requirement.

This rule was really intended for market fiduciaries, who have a fiduciary responsibility to customers and might be holding customer funds and prior to Dodd-Frank was never required of other commercial end-users.

Mr. BARBER. Thank you for the question, Mr. Chairman. This is certainly a contentious issue for my company and for agricultural companies in general. The amount of material that appears to be required is well beyond anything that has ever been handled before. Capturing commercial conversations as a pre-trade communication, when you consider the number of merchandisers and farmers and elevators in just the State of Kansas, we do not always know what is a pre-trade communication or what is just a conversation between a broker and a farmer or a feedlot operator. To try and capture all that and think that that is germane to the oversight seems way beyond the pale of what is necessary.

Chairman ROBERTS. What do you do with this? I mean, you are talking about keeping it for five years or whatever it was on top of whatever the transaction was. I mean, do you—I am wondering who inspects it. I mean, where is it? I mean, do you keep it on site or what?

Mr. BARBER. I would have to say I am not sure. The IT group in all companies have a tremendous struggle with it, and I think that is an echo of one of our questions, what will they do with it?

Is there—more material there than anyone can possibly decipher or make sense of. What is its real purpose? It just feels like a burden with no real solution to anything that is a problem.

Chairman ROBERTS. See if you can provide us with a real world, on-the-ground impacts that will come if the CFTC does not correctly define what it views to be a bona fide hedge to adequately provide the exemptions that hedgers, but not speculators, need, and any others on the panel are welcome to comment.

Mr. BARBER. Thank you for that. Certainly, again, harvest is not that far away for wheat, and coming——

Chairman ROBERTS. Such as it is, yes. Go ahead.

Mr. BARBER. —coming into a nice, beautiful harvest weekend and the local elevator knows that he is going to acquire probably a substantial amount of grain over that weekend and he is going to be exposed by putting out a bid to his local producers that, without clear direction that an anticipatory position is a hedge, he will probably be willing to pay much less to that producer because it increases his risk in the handling and the ownership of that grain than what he would if there was clarity that he would be within the appropriate regulation as a hedger, crystal clear, simple, that that is a direct impact.

Chairman ROBERTS. I appreciate that.

I am going to ask Senator Stabenow, but I just have a couple other questions, as well. Go ahead.

Senator STABENOW. Well, thank you very much, and thank you to all of you for your input.

Let me start with Mr. Cota. In your experience as president of your family's energy company in Vermont, and as someone representing small end-users, I think it is really important that we hear your input as it relates to smaller user companies managing risk in the derivative markets, and I wonder if you might speak a little bit more from that perspective, and what changes, if any, do you believe the committee should focus on to ensure open, fair, and transparent markets for small participants.

Mr. COTA. Thank you for the opportunity. As a small business, it is very difficult to do these hedges. The heating end of the industry that I represent requires a higher level of sophistication than most others because of its seasonality and how you have to blend contracts together in order to get it done. So, the changes that have been made have enabled people to actually be able to give consumers their energy costs fixed for the year or capped, which is even better, for a period of time, and blend those contracts together. A lot of that has been done with the changes from futures markets into option contracts and some derivative programs along with that. It is much easier to do that now in smaller units where they would not be able to do it. So, the consumer benefits through that reduced cost and the companies' costs have gone down. So, that has been a positive benefit.

Stability in these markets are critical. The option prices are a measurement of, really, what the volatility is, and the consumer is the one that ends up paying that. It does not matter what the market is. So, that has been a positive thing.

For changes that need to be done, one is that of the customer monies that are set aside is a critical issue. In most of our indus-

tries, the commodity costs are such a significant portion of the total business that if in a derivative that is not cleared and you do not have access to those funds, then that company is out of business. You may be held financially whole later, but it does not matter. You are out of business. So, that is an important element to the rule.

Penalties are really critical. Having somebody monitor the activities. You know, the CFTC needs funding. People miss the scope of things. The derivative markets is $700 trillion worldwide. The total world stock market is, like, what, $60 trillion. The SEC is in charge of the stock markets. The U.S. portion of these is, like, half, high leverage, still 35 times leverage. Energy, it is much higher. Some, for example, it is even greater still. So, these markets are so huge, and, so, having the CFTC have the funding just to get things done is critical. You need to know what the new rules are.

Senator STABENOW. Following up on that, you talked about the fact that, from a stability standpoint, small end-users, in particular, are counting on the CFTC to do their end of it, right, and clear, consistent rules that are fair and not overly burdensome, or hopefully not burdensome at all, but certainly not overly burdensome.

But, then, you also talked about the fact that there are large CFTC enforcement actions going on much, much larger, that, in fact, their enforcement budget, and you are recommending that we should increase the penalty authority as we look at reauthorization. I wonder if you might talk more about that, because there really is a concern that I have that if these penalties are too low, you just make it a cost of business and keep on going and it is not really protecting you or other end-users, people that are counting on this system to have integrity and accountability in it.

Mr. COTA. If it is not—if it is just a part of the cost of doing business, it has no prophylactic effect. There are lots of Ponzi schemes. If you take a look at the CFTC violations, there are tons and tons of violations. Many of them are very small Ponzi schemes relative to, say, the LIBOR scandal or something like that. But, they need to be proportional to what that profit was made in that transaction. Otherwise, it is not going to have any prophylactic effect.

If it is capped at a certain amount and the benefit turns out to be billions of dollars to that entity, then they are going to do that all day long. There is no reason for them not to. If it means that they have to hire more attorneys, well, guess what. More attorneys make more money. But, they are going to keep doing that transaction.

So, I think it needs to be some multiple of what the benefit was or what the damage was in order for it to have any impact. If it does not have an impact, the federal government has more money to spend.

Senator STABENOW. Thank you, and Mr. Chairman, I have more questions, but I know my time is up, so thank you.

Chairman ROBERTS. Senator Hoeven.

Senator HOEVEN. Thank you, Mr. Chairman.

We have to reauthorize the Commodity Exchange Act, and so I guess what I would like to hear from each of you are what are the most important issues we need to deal with in reauthorization and

the solutions. What is the top one or several issues you think we have to deal with in reauthorization and what you think we should do, starting with Mr. Duffy.

Mr. DUFFY. I am a big believer that the reauthorization process could probably be somewhere in the one-liner, with the exceptions that we have been discussing today, which is the end-user exemptions that need to be clarified. We have to take out the people that were not the causation of the 2008, 2009 crisis and let them go ahead and continue to do their business. So, I think that is critically important to do.

Also, which has been raised earlier, is the concern of the concentration of some of the smaller FCMs. You have to realize that the people that put food on the table in the United States of America, the producers of our country, from food to other products, they need a place to participate to do their trades, and more and more of these firms are getting—the smaller firms are getting onerous costs to do business today, so we are getting a concentration—we talked about it earlier—losing more firms.

Senator HOEVEN. Yes.

Mr. DUFFY. That is a big issue that we need to figure out with the firms and how we are going to expand this so the participants or the end-users can continue to do their business to benefit the rest of us in this country.

Senator HOEVEN. Mr. Barber.

Mr. BARBER. Thank you, Senator. I would certainly concur with Mr. Duffy's assessment. As an end-user, as a significant user and trader of these products, we would hope the committee would, as I said, look at what the intent of Dodd-Frank was and look at the gap that was created in how it has actually been implemented. What we have experienced is a serious overrun of regulatory reach way beyond what was intended. So, a return to that—and, certainly, if that requires more legislative action, we would commend you for doing that, to put the parameters back around that effort such that it regulates the swap market and the OTC markets that were the genesis of the problem that we had and not affect the market structures that, by and large, worked effectively for ag and energy producers and consumers prior to Dodd-Frank.

Senator HOEVEN. Mr. Walker.

Mr. WALKER. Thank you, Senator. The statute provides broad exemptive relief in the area of position limits for classes of market participants or classes of transactions today, and the CFTC should use that exemptive authority to more fully exempt commercial end-users from position limits. We believe that physical transactions should not be swaps, regardless of the fact of whether they have optionality in them or not, and we believe it is important not to treat commercial end-users as though they are a customer fiduciary or somebody that caused the financial crisis of 2008 by subjecting them to Regulation 1.35.

Senator HOEVEN. Mr. Bopp.

Mr. BOPP. Thank you, Senator. Number one, adopt the Chairman's legislation, S. 876, which would prevent non-financial end-users from being denied the very clearing exemption that is embedded in Dodd-Frank simply because they use a best practice, they

use these centralized treasury units. This is a bill, by the way, that passed the House last Congress by voice vote.

Number two, provide additional guidance. I think that our regulators are doing what they can to try to harmonize rules across borders. What we would appreciate as end-users is additional guidance to our regulators that they should take into account the views of end-users and the interests of end-users in trying to harmonize rules across borders.

Senator HOEVEN. Mr. Cota.

Mr. COTA. I would agree with Terry Duffy, and in addition increase penalties, as I said before, and full funding. Whenever you are having new rules, you need to get it done quickly. If there is not enough money to get the process done, then everyone is waiting for what the new game is. So, they need full funding for that.

Senator HOEVEN. Do you all agree that the Roberts legislation would address the end-user issue, starting with Mr. Duffy.

Mr. DUFFY. I do.

Mr. BARBER. Certainly, it is a significant improvement.

Senator HOEVEN. Mr. Walker, I guess you have already said.

Mr. Bopp.

Mr. BOPP. I do.

Senator HOEVEN. Mr. Cota.

Mr. COTA. We do not have a position on this legislation.

Senator HOEVEN. Last question. I do not know if it was Mr. Duffy or Mr. Barber, but one of you—so, we have talked about end-user. With the exception of Mr. Cota, you all feel that that would address the end-user issue, and I am disappointed I did not get to talk to the Chairman on that issue in terms of their flexibility.

But, the other question I have is for small companies, small providers. I do not know if it was Mr. Duffy or Mr. Barber who said that the regulatory burden is hurting the ability of the smaller companies to stay in the business. Of course, that means less competition, less service, not as good pricing for the customer. It also means concentration of risk. That is an important point. How do we address that? Is there legislation out there to do that? Does CFTC have the flexibility to do it without legislation? Two questions.

Mr. DUFFY. Real quick——

Senator HOEVEN. I would ask for some indulgence from the Chair, or I can come back if you would like me to do this in the second round, but can they answer that?

Chairman ROBERTS. Certainly, they can. We have a vote. It is ongoing.

Senator HOEVEN. I will be particularly tough on Mr. Cota for you, if you want——

[Laughter.]

Chairman ROBERTS. Well, he is really talking about the Klobuchar initiative as of last year. I wondered if that would help you change your mind, instead of me.

Chairman ROBERTS. I do not mean to put you on the spot. Why do we not just forget that. But——

Senator HOEVEN. I will wrap up, Mr. Chairman. The——

Chairman ROBERTS. Go ahead.

Senator HOEVEN. Does the CFTC have the flexibility to provide that regulatory relief now? If not, is there legislation out there that would accomplish that we could maybe incorporate in reauthorization?

Mr. DUFFY. I will try to answer very quickly, sir. Real quick, there is a business model problem embedded in the FCMs today. We talked about interest rates being where they are at today. A lot of the firms in the FCM world made money off of other people's money. Interest rates went to zero. In the meantime, trading exploded, but the cost of doing business went way down. Everybody benefited, except for one thing happened. Interest rates went down, so the business model for the FCMs went away. The big participants could always survive that. The smaller participants cannot.

What is critically important is we cannot have burdensome rules that apply to the banks that apply to small FCMs in the same way, because these small FCMs do not have the deep pockets that the banks have today and over 50 percent of the activity being done today in regulated futures market is done by smaller participants.

Senator HOEVEN. Is the flexibility there for the regulators to give them the relief? Is legislation needed? Which?

Mr. DUFFY. I do not believe—I do not know if they can create legislation on how to run a business. I do not know if that is appropriate or not——

Senator HOEVEN. Regulatory relief.

Mr. DUFFY. Regulatory relief is a different issue and I think we have to look at all the different rules that apply to banks and smaller FCMs, and I think that is, again, what this hearing is about, is to exempt some of the end-users who participate in these smaller firms, not in the bank firms.

Senator HOEVEN. Mr. Barber.

Mr. BARBER. Yes. I mean, I think that was covered well by Mr. Duffy and in his comments. Certainly, the CFTC has a lot of places that they could relieve some regulatory pressure on smaller entities.

Senator HOEVEN. Does anyone else have something they want to add on that issue?

[No response.]

Senator HOEVEN. Okay. Thank you.

Chairman ROBERTS. This will conclude our hearing. I want to thank all witnesses.

I ask unanimous consent that the report by former CBO Director Douglas Holtz-Eakin be entered in the record at this point. So ordered.

[The following information can be found on page 106 in the appendix.]

Chairman ROBERTS. Mr. Barber, as a conclusion, that report said that the cost of Dodd-Frank compliance could reduce GDP by $895 billion from 2016 to 2025, and you mentioned in your testimony that the compliance cost for ADM's FCMs have doubled in the past five years. Simple question: Do you find you are now spending more and more time and money complying with rules and regulations which create distractions from the crucial risk mitigation services that you provide our farmers and ranchers?

Mr. BARBER. Thank you for the question, Chairman, and the ability to conclude. Absolutely. In a market that essentially functioned well for us previously, we are spending substantial amounts of resources dealing with a regulatory scheme that was not in place prior to Dodd-Frank and that has not helped our markets function any better or created a safer marketplace.

Chairman ROBERTS. I appreciate that. I appreciate the panel.

This concludes the hearing.

[Whereupon, at 12:08 p.m., the committee was adjourned.]

A P P E N D I X

MAY 14, 2015

Testimony of
Bruce Barber
General Manager, Oilseed Risk Management
ADM

On behalf of
Commodity Markets Council

Before the
U.S. Senate Committee on Agriculture
Washington, DC

May 14, 2015

Chairman Roberts, Ranking Member Stabenow and Members of the Committee: thank you for holding this hearing to discuss the regulatory burdens impacting end-users and market liquidity as they relate to reauthorization of the Commodity Futures Trading Commission ("CFTC" or "Commission"). My name is Bruce Barber, General Manager of Oilseed Risk Management at ADM. I am testifying today on behalf of the Commodity Markets Council ("CMC").

CMC is a trade association that brings together exchanges and their industry counterparts. Our members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Our industry member firms include regular users and members of such designated contract markets (each, a "DCM") as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of swap execution facilities (each, a "SEF"). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs or over-the-counter ("OTC") markets. As a result, CMC is well positioned to provide consensus views of commercial end-users of derivatives with respect to CFTC reauthorization.

For more than a century, the people of Archer Daniels Midland Company (NYSE: ADM) have transformed crops into products that serve the vital needs of a growing world. Today, we are one of the world's largest agricultural processors and food ingredient providers, with more than 33,000 employees serving customers in more than 140 countries. With a global value chain that includes more than 460 crop procurement locations, 300 ingredient manufacturing facilities, 40 innovation centers and the world's premier crop transportation network; we connect the harvest to the home, making products for food, animal feed, chemical and energy uses.

As Congress seeks to once again reauthorize the CFTC, hedgers of agricultural commodities and energy products appreciate being asked if we are better off in today's regulatory environment as compared to the days before Dodd-Frank. Unfortunately, that is still a difficult question to answer as there are still critical pieces of the regulatory puzzle that are not yet resolved. It

should also be stated up front that no exchange, no DCM, no clearing house and no commodity end-user of derivatives was bailed out of insolvency with tax payer money during the financial crisis of 2008 that brought us Dodd-Frank.

Since the passage of Dodd-Frank, many new regulations have been implemented without consideration of the real costs on commodity producers or consumers. CMC has provided the CFTC and other regulators a great deal of information in an effort to help them understand how our members use derivatives markets to reduce our operational risks. We have also made numerous efforts to seek clarity in who is affected and more importantly how to comply.

Yet despite our best efforts to work within the realities of a post Dodd-Frank world, what I can tell you is that our compliance costs are up substantially. The compliance expenditures for ADM Investor Services, ADM's FCM, have doubled in the past five years. CMC members are finding that much of the most problematic red tape that we are now confronted with was not compelled by Dodd-Frank. In fact, some time ago, the CFTC's nearly five-year effort to implement new rules for clearing swaps somehow morphed into an effort to rewrite many long-standing ***futures*** market regulations that Congress, via Dodd-Frank, never contemplated. Congress went out of its way to keep agricultural and energy end-users out of the Dodd-Frank line-of-fire. Our message to you today is that five years later, we find ourselves in the middle of the fight.

CMC is appreciative of the Commission's improved and appropriate emphasis on end-user issues during Chairman Massad's tenure. We couldn't agree more with his statements such as:

"The ability of participants in the agricultural sector to hedge commercial exposure is critical to having a successful agricultural industry and to putting food on the table for all of us"

"Our goal is not to create unnecessary burdens on commercial end-users, but to build a reliable orderly framework for oversight in which vibrant markets can thrive."

Commissioner Giancarlo has been more candid:

"If we replace farmer's commercial risk management decisions with Washington's risk management assumptions, we're all in for a lot of trouble."

"We must always ensure that the rules we write are smart, efficient, and do no harm."

To CMC members, such comments are a tacit recognition that some of these rules have not been smart or efficient, and even have the potential to do harm, particularly to end-users and the markets they use to manage risks so that farmers earn more for the crops they produce and consumers pay less for food, fuel and energy. A reliable framework for oversight of the futures markets was already established before the passage of Dodd-Frank. Many CMC members would describe this situation as an example of process failure. During this reauthorization process, we would ask this Committee to focus its efforts on the contrast between the congressional intent

of Dodd-Frank's Title VII versus today's reality of how it is being implemented in an effort to address these process failures.

The additional regulatory costs that a multitude of new CFTC rules have foisted upon end-users and commercial participants will ultimately be passed on to producers and consumers as those costs work their way through the supply chain. There will also be an impact on market liquidity, which will further raise the costs of risk management and ultimately the cost of finished agricultural and energy goods. In other words, if Dodd Frank is not implemented as Congress intended, this law will hurt the folks that it was intended to help.

For example, since President Obama signed Dodd-Frank nearly five years ago, the Commission has issued 274 no-action letters, 20 interpretive letters and 64 exemptive letters all providing different levels of regulatory relief to CFTC rules. This compares to 201 no action letters during the decade prior to Dodd-Frank. By stating these numbers we do not mean to suggest that this nearly ***tripling*** of no-action relief should be curtailed. What we do mean to provide with these numbers is some perspective in terms of the regulatory burden and dramatic increase in the level of uncertainty that CMC members face in the wake of thousands of pages of new Dodd-Frank regulations. The implementation of Dodd-Frank has been significantly lacking in clarity, yet CMC members also know that mistakes in compliance are often greeted with punitive penalties.

More recently, CMC has been quite pleased with the Commission's efforts to reconstitute several advisory committees, which had not met in several years. The uptick in the number of public Roundtable discussions on a variety of important topics has also been a refreshing change. All four Commissioners' willingness to listen to end-user concerns in an effort to achieve clarity is appreciated and noteworthy.

However, there are important issues that warrant Congress' attention in the context of CFTC reauthorization, all of which fall under a need for more clarity and a redirection of the regulatory process to better reflect Congressional intent.

End-User Concerns

CMC recognized the need for and supported reform in the over-the-counter (OTC) swaps market and believes that Dodd-Frank provided a foundation for an effective overhaul of this important risk-management market. However, there are various issues that have arisen as part of the implementation process which we believe the Committee should revisit going forward.

1. Rule 1.35

CMC recognizes the Commission's actions to amend CFTC Regulation 1.35 ("Rule 1.35") and applauds its efforts. However, CMC members still believe that the costs and burdens associated with Rule 1.35 as currently written vastly outweigh any benefits. CMC members

remain concerned about the scope of Rule 1.35's requirement to retain written communications made via "digital or electronic media" that "lead to the execution of transactions in a commodity interest and related cash or forward transactions" ("pre-trade communications"). Although unregistered members of a DCM or SEF are now exempted from the requirement to retain text messages, unregistered and registered CMC members are still troubled by the requirement to retain written and electronic records of pre-trade communications.

CMC members believe the proposed changes do not go far enough in providing relief and that the rule will force members to either withdraw from or forego membership in DCMs and SEFs, or, out of an abundance of caution, spend significant amounts of time and resources in a commercially impracticable attempt to capture all required records. Further, CMC members would like additional clarification regarding what constitutes a "text message" under the proposed amendments. CMC believes that the Commission should encourage membership in DCMs and SEFs in order to further promote transparency in the marketplace and to reduce costs for consumers of commodities. If further relief and clarification is not provided, Rule 1.35 will discourage membership in DCMs and SEFs, which will in effect reduce transparency in the marketplace, limit the ability of commercial firms to utilize modern and efficient means of communication, and lead to legal and regulatory uncertainty for end-users and customers.

2. Deliverable Supply Estimates

CMC requests that the Commission make a determination about the deliverable supply estimates for each of the twenty-eight physical commodities covered by the CFTC's proposed rule that will serve as the baseline for spot month position limits. Until a proper deliverable supply baseline is established, it will be impossible to assess the appropriate long or short spot month limits that may be set for individual contract markets.

The Commission has received updated deliverable supply data from affected contract markets which CMC believes are conservative estimates. CMC urges the Commission to make an objective economic study of the relevant physical commodities that could be delivered upon expiry.

Additionally, CMC encourages the Commission to analyze physical markets in an objective fashion that is appropriate for each commodity asset class. The Commission should consider domestic storage capacity, real time production levels and historic import activity for asset classes such as oil and gas. In addition, the Commission should consider refinery capacity when considering deliverable supply for gasoline or other refined products. For grains and soft commodities, storage capacities and flows of the relevant commodity in areas that are in and tributary to the specified delivery points should provide a realistic estimate of deliverable supply.

With an objective economic study made (and an opportunity for public comments), the Commission will be in a better position to deliberate and decide, if necessary, on the

appropriate federal spot month position limit levels for each of the relevant commodity asset classes. Upon establishment of federal limits based on updated deliverable supply estimates, the applicable designated contract markets also will be able to continue to use their discretion in setting exchange specific limits below the federal limits as necessary and appropriate to reduce the potential threat of market manipulation or congestion.

3. *Bona Fide* Hedging

Commercial and end-user firms accept and manage several different types of risks in the supply chain that impact producer and consumer prices. Examples of risks are below:

- Absolute contract price risk with the counterparty (or flat price)
- Relative price risk (basis and calendar spread risk) - unfixed
- Time, location and quality risk
- Execution / logistics risk
- Credit / counterparty default risk
- Weather risk
- Sovereign / government policy risk

All of the above risks directly impact the commercial operations of a merchant and ultimately affect the value of the merchant's commercial enterprise (including the price the merchant pays and receives for a product). In each and every transaction, the above identified risks, including potentially others, are not the same and the relationship between them is constantly in flux. As a result the merchant must make a decision how to not only price the risk in the commercial transaction, but more importantly, how to actively hedge and manage the risks. For instance, in negotiating a forward contract with a potential counterparty, the merchant must take into consideration all of these and will make the most appropriate decision on if/when/how to utilize exchange traded futures contracts to hedge the multiple risks that are present. All of these risks affect price. In other words, the hedging of all of these risks is directly hedging price risk.

The fundamental principle is this: price risk is far more complex than just fixed-price risk, but may include volatility and similar non-linear risks associated with prices, and a transaction to hedge any of these risks in connection with a commercial business should receive *bona fide* hedging treatment. Regulators should not condition *bona fide* hedging treatment as available only when risk crystalizes by virtue of a firm holding a physical position or by entering into a contract. Commercial market practices would be severely impacted if hedging transactions were not deemed *bona fide* hedges. We ask this oversight Committee to help ensure that CFTC regulation empowers commercial and end-user firms to manage risk to the fullest extent possible.

Unfortunately, the CFTC is taking a different course by seeking to adopt a narrow view of risk. Within the CFTC's proposed position limits rule, the Commission has chosen to focus solely

on the absolute price risk of a transaction with a counterparty, and is not considering the multitude of risks in the commercial operations of enterprises.

By narrowly defining *bona fide* hedging, the traditional hedger will be compromised and thus will not be able to effectively manage its risks. If this happens, risk premiums are going to rise throughout the business, which will be passed along the supply chain. Bid/offer spreads will widen and liquidity will be substantially reduced. This narrow view of hedging, if adopted, will mean that producer prices will decline and the cost to the consumer will increase.

Commercial producers, merchants and end-users have provided numerous examples to the Commission in the last three comment letter periods and have explained how detrimental it would be to constrain the market participants that are *bona fide* hedgers. A summary of several areas of concern related to hedging in the CFTC's proposed position limits rule follow below.

- *Anticipatory Hedging, Merchandising, & Processing*

Within Title VII of Dodd-Frank and in the Commodity Exchange Act ("CEA"), Congress explicitly referred to anticipatory and merchandising hedging as bona fide hedging methods because they are crucial to the risk management functions of commercial and end-user firms. Anticipatory hedging allows commercial firms to mitigate commercial risk that can reasonably be ascertained to occur in the future as part of normal risk management practices. Merchandising activity enables producers to place commodities into the value or supply chains and ultimately brings those commodities to consumers with minimal price volatility.

In addition, merchandising activity promotes market convergence – a crucial aspect of the price discovery function commodity markets serve. A reduction in the efficiency of convergence increases risk, reduces liquidity, and ultimately may lead to both higher consumer prices and lower producer prices. Allowing the full scope of hedging activity promotes more efficient, effective and transparent markets – exactly the public policy goals of the Commission.

Also of concern is the issue of the anticipatory processing hedge. While the Commission's proposed rule states that such hedges are *bona fide*, the proposed rule simultaneously extinguishes the utility of the exemption by stating that anticipatory processing positions will only be recognized as *bona fide* if all legs of the processing hedge are entered into equally and contemporaneously. Hedging is based on human assessment of risk at any given time. Sometimes it is best to hedge just one leg of processing exposure. The proposed parameters around the processing hedge exemption not only fail to recognize market dynamics; worse, they put the Commission in the position of defining risk and mandating how that risk must be hedged in the market.

- *Economically Appropriate Risk Management Activities*

CMC would also like to express concern to this Committee with language in the CFTC's proposed position limits rule which suggests that a *bona fide* hedge only exists when the net

price risk in some defined set is reduced. This is inconsistent with the manner in which a commercial firm evaluates risk – which is not limited to price risk, as mentioned above. The most appropriate way to deem a derivatives transaction as "economically appropriate" is whether a commercial firm has a risk abated by the transaction, and such risk arose in its commercial business.

Linking the ability to engage in *bona fide* hedging to a net reduction in risks across an entire enterprise, corporate family, or separately-managed lines of business is not consistent with how commercial firms commonly address risk. Moreover, individual firms identify which risks they want to accept. A transaction that may be risk reducing on one side of a business, but leave an opposite risk unhedged in another part of the business might serve legitimate business purposes. Thus, to impose a "net price risk" formula across a corporate group for purposes of *bona fide* hedging effectively replaces a commercial firm's business judgment with regulatory prescription.

- *Non-Enumerated Hedges*

Non-enumerated *bona fide* hedges are important to commercial market participants, as they allow additional flexibility for firms to hedge risk in ways that are unforeseen. However, the ability to utilize these non-enumerated hedges is often dependent upon utilizing the hedging strategy in real time in response to fluid market conditions. Specifically, merchandisers and other intermediaries (physical, financial and risk, among others) play a vital role in helping end-users understand and ultimately reduce their risks. To the extent that these merchandisers and other intermediaries are unable to get exemptions for the hedges they require to provide these services, risk mitigation will be reduced and overall systemic risk will increase.

CMC supports allowing market participants to engage in non-enumerated hedging activity subject to a reasonable review period similar to that contained within current CFTC Regulation 1.47. In addition, we would like to emphasize that the expertise of the exchanges should continue to be drawn upon by the Commission to allow a timely review of these petitions in the most efficient manner for the Commission.

- *Cross-Hedging*

Cross-hedging is another important hedging tool for commercial participants, and is particularly important for commodities which may be processed or transformed into products which may not be traded commodities. CMC believes that commercial firms should be granted the discretion to determine what relationships between two positions are correlated sufficiently to be considered "substantially related." The CFTC has advanced a notion of a bright-line test with respect to the regulation of cross-hedges. The decision to use a cross-hedge is multi-factored, and commercial businesses have a natural profit incentive to achieve as great a correlation as possible. However, a fixed correlation is not always achievable, and sometimes risk managers are limited in their selection to what products are available. CMC members believe that a position limits regime where risk managers can freely select their cross-hedges, report them as

such, and stand ready to explain them to the Commission if necessary is the proper regulatory path.

CMC has urged that the Commission not impose an arbitrary deadline upon which market participants engaged in cross-hedging must exit their hedges in the spot month, near month, or in the last five trading days. DCMs should be permitted to set restrictions on a contract-by-contract basis, recognizing the unique characteristics of each individual commodity and contract, and the need (or lack thereof) for commercial end-users to continue to utilize cross-commodity hedges in a specific market during the spot month, near month, or in the last five trading days.

- *Gross and Net Hedging*

CMC continues to request that the Commission allow end-users to utilize both "gross hedging" and "net hedging" concepts when managing risk. The Commission uses concepts of both "gross hedging" and "net hedging" in its discussion of the economically appropriate requirement, but these terms are not separately defined, and the context in which they appear does not fully inform their meaning. CMC understands gross hedging to be the practice of separately hedging each of two or more related positions. Net hedging happens when that firm nets its cash purchase and sale contracts to a net long or short position and then offsets that risk by entering into short or long derivatives transactions, respectively. It is crucial that the Commission affirm that each of these methods entail derivatives that would be eligible for *bona fide* hedging treatment. Additionally, when utilizing gross hedging, firms should have the flexibility to hedge either the gross long or the gross short when this is the most economically appropriate risk management position.

- *Wheat Equivalence Determinations*

It is critical to maintain equality among the three U.S. Wheat markets: Chicago, Kansas City and Minneapolis. Currently, each market has the same spot month limit and the same single-month and all-months-combined limit. Regardless of the level at which these limits are set, parity should be maintained among these three markets. Different limits for the same type (but not necessarily variety) of commodity could dramatically impact the growth or potential for risk mitigating strategies between the contract markets. In the case of wheat, this is particularly critical given the nature of the three differing varieties. Having three varieties provides not only additional opportunities for market participants to reduce risk through spread trades, but also provides opportunity for hedging and risk management by commercial participants between markets in response to domestic or global economic factors.

4. Trade Options

CMC is urging the Commission not to categorize trade options as referenced contracts subject to position limits. These physical options, including physical forward transactions with embedded volumetric optionality, are an important tool in physical commodity markets. Trade

options may be used to manage, among other things, supply chain risk, price risk, or both. Subjecting these products to federal position limits could severely harm the efficient operation of physical commodity markets and increase costs for end-users.

Trade options do not trade like physical futures and cannot simply be traded out of or unwound prior to the spot month. In the spot month, a trade option that does not qualify as a "*bona fide* hedging position" could only be offset with another physical position to bring the net position within the applicable position limit. Taking on a physical position in order to offset a trade option for position limit purposes could introduce new risks to the market participant and would undermine the entire purpose the market participant entered into a trade option in the first place. Such a result would be extremely disruptive to the physical markets.

The burden on market participants associated with speculative position limits on trade options would be substantial. Market participants would be required, for the first time, to track trade options separately from spot and forward contracts, develop systems to calculate the futures contract equivalents for these physical-delivery agreements, and, ultimately, monitor trade option positions for compliance with applicable limits.

5. Aggregation

CMC is recommending that the CFTC not pursue aggregation of positions only based upon affiliation or ownership. Instead, the Commission should require aggregation of positions where an entity controls the day-to-day trading of a portfolio of speculative positions. In the past, Commission staff highlighted the possibility of using the independent account controller safe harbor as a model for not requiring aggregation among related companies where there is ownership but not control. CMC applauds this approach and believes it may provide a useful framework for capturing the purposes of position limits while not unduly burdening otherwise separate trading activities.

Towards that end, CMC recommends the Commission adopt an exemption from the requirement that persons under common control ("excluded affiliates") aggregate their positions under certain circumstances described below.

Accounts of entities under common ownership need not be aggregated where the entities are excluded affiliates. An excluded affiliate should be defined as a separately organized legal entity:

> (1) That is specifically authorized by a parent entity to control trading decisions on its own behalf, without the day-to-day direction of the parent entity or any other affiliate;
>
> (2) Over whose trading the parent entity maintains only such minimum control as is consistent with its fiduciary responsibilities to fulfill its duty to supervise diligently the trading of the excluded affiliate or as is consistent with such other legal rights or

obligations which may be incumbent upon the parent entity to fulfill (including policies and procedures to manage enterprise wide risk);

(3) That trades independently of the parent entity and of any other affiliate; and

(4) That has no knowledge of trading decisions of the parent or any other affiliate.

CMC appreciates the Committee's consideration of our views regarding the regulation of *bona fide* hedging.

6. The Swap Dealer *De Minimis* Level

End users of derivatives are also concerned about the CFTC's rule regarding the definition of "swap dealer." Under the rule the non-special entity *de minimis* level is currently $8 billion gross notional of swap dealing in a 12 month period; however that amount is set to drop automatically to $3 billion by the end of 2017 unless the CFTC takes action.

The CFTC's final rule contains no rationale as to why a 60% drop in the swap dealer *de minimis* level is necessary nor what the impact of such a drop may be on the market. For end users however the results are clear: fewer counterparties with whom end users can hedge, a significant decrease in market liquidity and further consolidation of swap dealing into a handful of large financial institutions.

If the CFTC is to lower the *de minimis* level it should only be after careful deliberation and impact analysis, including giving the public an opportunity to comment. In at least one area the Commission already knows the consequences of setting the *de minimis* level too low: when municipal utilities found they were to be treated like "special entities," subjecting their counterparties to a $400 million swap dealer threshold, these utilities discovered very few counterparties were willing to offer them risk management solutions. One of Chairman Massad's first acts as Chairman was to amend the swap dealer rule to allow municipal utility related swaps to be subject to the $8 billion threshold. This move was both prudent and highly welcome.

For end users a lower swap dealer *de minimis* level will not mean end users have more registered swap dealers with whom to deal. For a variety of reasons including business models and operational costs it seems apparent that entities that wish to be registered as swap dealers have already largely done so. Instead a lower *de minimis* level will mean that market participants (especially in the energy and commodity markets) will no longer be able to offer risk management services alongside the physical delivery arrangements they currently have in place with their customers. The end result is likely to be less liquidity and higher volatility in commodity prices.

CMC believes the self-executing provision in this rule as well as the provision that was recently reversed by the CFTC involving its residual interest rule are fundamentally flawed. We applaud

the Commission for their reversal on residual interest and urge this Committee to encourage the Commission to do the same regarding the swap dealer *de minimis* level by establishing the swap dealer *de minimis* level be set at the current size of $8 billion, and require that it be lowered only after a new rulemaking giving the public, including those end users that would be most affected by such a drop, the opportunity to comment. While the current rule provides the CFTC is to conduct a study on the appropriate level, without a new rule or action by Congress the level will still automatically drop. For end users this uncertainty can only be resolved by congressional action.

7. International Harmonization

In addition to these specific regulatory topics, CMC encourages Congress and the CFTC to continue to seek resolution to international regulatory issues. Two in particular are US-EU equivalence and the Basel III Supplemental Leverage Ratio. With regard to the US-EU equivalence issue, the lack of an equivalence determination has significant impacts to end-users that operate globally and depend on access to US exchanges and clearinghouse for risk management. For example, right now U.S. futures contracts count as "OTC derivatives" under the European Market Infrastructure Regulation ("EMIR") because US futures exchanges have not yet been "recognized" by European regulators. This creates a disincentive for commercial end-users (Non-financial counterparties, or NFCs under the EMIR construct) that prefer not to be subject to the EMIR OTC thresholds and registration requirements as an NFC+. We are encouraged by recent progress on the broader equivalence debate and hope to see this resolved soon.

With respect to the Basel III Leverage Ratio issue, CMC members are deeply concerned that the leverage ratio will significantly increase the cost of hedging for end-users. Many of CMC's members use bank affiliated FCMs, which are subject to Basel III requirements, to access the futures markets to perform critical risk management functions. While the CFTC has taken great measures (*i.e.* gross margining at CCPs, improvements to CFTC Rule 1.25, residual interest requirements) to enhance the protection of segregated customer funds held by an FCM, the Leverage Ratio framework suggests that bank-affiliated FCMs may use those very customer funds to leverage themselves. Furthermore, the exposure measure in the Leverage Ratio is punitive to commodity hedge portfolios, rendering many commodity end-users undesirable for a bank-affiliated FCM, despite having a better counterparty credit profile than many speculative users of the same markets. As a consequence of these new requirements, some CMC members report having received notice from their FCMs of new fees earlier this year, while others have been told simply that the FCM can no longer support that client's business due to the high capital burden. CMC members are very concerned with the sharp decline in the number of FCMs. Recently, another major non-bank affiliated FCM exited the business indicating that access to clearing can no longer be considered a given.

Conclusion

Commodity derivatives markets continue to grow and prosper. They have become deeper and more liquid, thereby narrowing bid/ask spreads, and improving hedging effectiveness and price discovery. All of these developments benefit much more than just those who trade commodities. Efficient derivatives markets offer providers of food and energy the ability to reduce the multitude of risks they must manage. Consumers are the ultimate beneficiary of these efficiencies.

The swaps market reforms in Dodd-Frank were not required because of problems in physical commodity markets. Commercial end-users of agricultural and energy futures had no role in creating the financial crisis. In fact, the regulated futures market fared well throughout the financial crisis. CMC members recognize the need for the Dodd-Frank Act and support its goals, yet these regulations should be efficient and reasonable rather than overly prescriptive and complex.

We believe that as Congress considers how the CFTC is to regulate in the future, it should use the core principles on which the CFTC was founded as its guide. A balance must be maintained between regulatory zeal and consideration as to how regulatory changes could result in negative consequences to not just CMC members in the middle of the food and energy chain, but also to the producers and consumers on each side of the chain. Undue regulatory interference with the hedging mechanism introduces risk that must be priced into the chain, negatively affecting both ends and everything in between. Given this, we strongly believe that the CFTC's post Dodd-Frank trend toward very prescriptive changes to futures market regulation will hinder rather than improve our economy's ability to manage commodity market risks.

While the CFTC must continue to evolve in order to adequately regulate increasingly complex derivatives markets, many of these pending changes also introduce the potential for regulators to *create* risk and increase costs by going beyond their purview. Doing so, without consideration of the consequences, is dangerous and goes against both the "do no harm" principle of regulation as well as the CFTC's core principle regulatory heritage.

Compliance costs for end-users have skyrocketed. Today, agriculture and energy end-users are faced with thousands of pages of new CFTC rules that no one person can comprehend followed by a multitude of letters issued by the Commission to clarify rule language, extend compliance dates, or provide temporary no-action relief.

But the problem isn't only that this complexity and regulatory uncertainty adds unnecessary costs. It is also that, uncertainty, *via* additional regulation of the risk management tools that commodity market participants utilize, *actually creates risk* where it did not previously exist.

CMC members mitigate risks by hedging. The fact that future regulation may determine that the risk management methods we have described here today may no longer be considered hedging is of enormous concern and is an example of where risk could be created.

When regulatory initiatives lack clarity or evolve to be at cross-purposes with the core principles on which the Commission was founded, CMC members are compelled to reach out to this Committee for help. Thank you for this opportunity to testify. We look forward to continuing to work with this Committee to strike the right balance.

I look forward to your questions.

Hearing before the Committee on Agriculture, Nutrition & Forestry

United States Senate

106 Dirksen Senate Office Building

"Regulatory Issues Impacting End-Users and Market Liquidity"

Testimony of Michael D. Bopp
Partner, Gibson, Dunn & Crutcher LLP on behalf of the Coalition for Derivatives End-Users
May 14, 2015

Chairman Roberts, Ranking Member Stabenow, other members of the Committee,
I am Michael Bopp, a Partner at the law firm Gibson, Dunn & Crutcher LLP and Counsel to the Coalition for Derivatives End-Users. I want to thank you for inviting the Coalition for Derivatives End-Users to be represented at this important hearing. The Coalition includes roughly 300 end-user companies and trade associations and, collectively, we represent thousands of end-users from across the economy that employ derivatives to manage everyday business risks. The Coalition supports regulation that promotes economic stability and transparency without imposing undue burdens on derivatives end-users. We believe that imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, restricts job growth, decreases productive investment, and hampers U.S. competitiveness in the global economy.

The Coalition appreciates the bipartisan efforts by the Members of the Committee on behalf of American companies who use derivatives to manage many of the risks they face in running their businesses. In particular, end-users applaud Congress' passage, earlier this year, of legislation providing them relief from the mandatory initial and variation margin requirements. Seventeen members of this committee opposed an amendment that would have stripped the end-user margin bill from the Terrorism Risk Insurance Act legislation to which it was attached. We are very grateful for your support of main street businesses.

The Coalition also appreciates and supports the Chairman's introduction of the centralized treasury unit (CTU) bill, S.876, which would prevent end-user companies from being denied use of the clearing exemption in Dodd-Frank drafted specifically for them.

The Coalition concurs with the broad consensus that end-users should not be subject to regulations designed to reduce the risk of those who maintain derivatives positions that could pose risk to the financial system. End-users employ derivatives to mitigate the risks that arise from business operations and do not engage in the type of trading that cause risk to our financial system.

As the implementation of derivatives regulation continues in both the U.S. and abroad, and other aspects of the financial crisis are addressed, end-users are facing uncertainty and costly regulatory burdens on a number of fronts. The result of this uncertainty and expense is that end-users are being forced to consider foregoing hedging transactions, entering into less efficient

transactions or placing themselves at a competitive disadvantage to other market participants. In particular, the three areas where we believe congressional attention would help address inefficiencies and unnecessary expense are as follows:

- CTUs engaging in inter-affiliate and external-facing derivatives transactions;
- Capital and liquidity requirements applicable to derivatives transactions;
- Cross-border, market fragmentation and liquidity concerns.

Centralized Treasury Units

Many non-financial end-users employ centralized treasury units to reduce risk by having a single entity centralize and net the hedging needs of all of its affiliates. In fact, nearly half of the respondents to a Coalition survey indicated that they use CTUs to execute over-the-counter (OTC) derivatives. This makes sense, as many companies find it more efficient to manage their risk centrally by netting exposures and having one affiliate trade in the open market, instead of dozens or hundreds of affiliates trading with third parties in uncoordinated fashion.

Section 723 of the Dodd-Frank Act makes the end-user clearing exception available to only those separate, CTUs that "act[] on behalf of the [affiliate] and as an agent." In other words, CTUs that are financial in nature and that act as a "principal" in trades for affiliates would not be eligible for the end-user clearing exception. This distinction in existing law renders the provision irrelevant as CTUs that operate in an "agent" capacity are not party to a swap and the non-financial affiliates on whose behalf they are trading are themselves exempt from mandatory clearing and margin requirements.

The reality is that most end-user CTUs that are separate legal entities act in a principal capacity in order to net exposures, consolidate hedging expertise and maximize efficiencies. By using CTUs in this way, non-financial companies are denied the end-user clearing exception even though their non-financial affiliates can go to the market directly without having to clear their trades. This is an anomalous result. Forcing an end-user's non-financial affiliates to enter into trades directly with external counterparties simply increases risk to the corporate family as a whole and risk to the market more generally as potentially offsetting trades cannot be netted, resulting in significantly more externally facing trades with third-parties.

For these reasons, the CFTC has recognized the value provided by CTUs that operate in a principal capacity and granted relief through the staff no-action process. The Coalition is very appreciative of this well-intended relief.

In light of the no action relief, some have asked whether legislation is still needed. The answer is "yes". Put simply, a no-action letter doesn't change the law. It is an assurance from the agency staff that they will not open an enforcement action for a violation of the law; the law itself remains unchanged. As a result, the no-action process is not sufficient for many companies, especially public companies and their boards that, under Dodd-Frank and the CFTC's no-action letter, need to certify that they are eligible for the clearing exception, which is technically not true. This outcome has competitive ramifications, as under European law, CTUs are not treated

as financial entities. Consequently, European law does not apply clearing and other requirements to CTUs of non-financial end-users.
The Dodd-Frank Act does not define the term "end-user". As a result, when an agency needs to define a non-financial"end-user" in a regulation, it refers to the section of Dodd-Frank that created the end-user clearing exception. In other words, an end-user is a company that is eligible for the exception. The only problem is, some end-users are technically not eligible – in spite of the no action relief – because they use CTUs. This is a problem because it means the glitch in Dodd-Frank gets propagated through every regulation that references an end-user. The solution, of course, is to fix the glitch. And that is what the Chairman's CTU bill does.

The Coalition strongly supports S.876, sponsored by Chairman Roberts and, in the last Congress, Senators Collins and Klobuchar. The bill would clarify that certain swaps entered into by a CTU when it is hedging the commercial risk of a non-financial affiliate as "principal" are eligible for the end-user exceptions from mandatory clearing and the requirement to post margin for their derivatives positions. The bill is narrowly tailored to address the needs of non-financial end-users. The bill would not permit the trades of financial entities or speculative trades to take advantage of the exception, and does not increase the likelihood of evasion under the provisions of the Dodd-Frank Act or CFTC regulations. The bill would allow the CFTC to deploy staff to matters other than the overly complex task of monitoring end-user compliance with the complicated and changing conditions of their no-action relief.

Non-financial end-users that operate CTUs do so because they provide an efficient, cost-effective and risk reducing means of managing and hedging the exposures of their affiliated operating entities. The risk-mitigating function of aggregating exposures on the books of a special-purpose subsidiary within their corporate group, netting the inter-affiliate exposures, and then entering into smaller derivatives with a bank or other swap dealer for the net amounts is an industry best practice. Without the certainty of legislative relief, companies could be forced to rethink or wind down these units and hedge less efficiently or meet burdensome new regulatory requirements. The cost of the latter option is extremely difficult to justify given that the operating entities on whose behalf the CTU is hedging are themselves exempt from mandatory clearing and margin requirements. Given these choices, it is possible that end-users may also be forced to contemplate simply retaining more risk.

Capital and Liquidity Requirements

In an effort to lessen the costs and impact on end-users seeking to hedge risk, the Dodd-Frank Act provided relief from a number of regulatory burdens, including trade execution and clearing requirements. Subsequently, relief was also provided to end-users from burdensome margin requirements. Unfortunately, this relief is in danger of being eroded by costs associated with increased capital requirements for derivatives transactions.

To protect banks and the financial markets from the stress experienced in 2008, the U.S. Prudential Banking Regulators have finalized rules implementing Basel III, requiring our bank counterparties to hold more capital against their derivatives positions. With additional capital and liquidity measures still being promulgated, including the Net Stable Funding Ratio and other outstanding Basel capital reforms, bank counterparties will see additional requirements that

result in increased transaction costs. Bank counterparties will seek to recover these costs by passing them on to end-users seeking to use derivatives to hedge their business risks.

There are alternatives however. For example, European capital charges on derivatives positions are significantly more favorable to end-users than parallel charges in the United States. European policy makers have recognized that end-users' hedging activities are risk reducing and therefore require less capital as compared to financial entities keeping open positions or making markets in derivatives. The European rules exempt transactions with non-financial end-users from certain of the additional capital requirements. The indirect costs imposed by U.S. Prudential Banking Regulators are real and impact end-users and their decisions about managing risk. The impact could be significant enough to put American companies at a meaningful competitive disadvantage compared to European competitors. We therefore suggest that U.S. Prudential Regulators reassess how the capital rules are impacting end users and make adjustments to reduce unnecessary burdens and costs.

Cross Border Concerns

The Coalition recognizes the efforts being made by regulators in the U.S. and abroad to resolve differences that exist between different countries' regulatory regimes. The global nature of the derivatives markets adds levels of complexity to this exercise. As more foreign jurisdictions begin implementation of their regulations, end-users are turning their attention to other new regulatory regimes.

As new foreign regulations begin impacting non-U.S. affiliates and more cross-border transactions, multinational companies, as they did with the implementation of the Dodd-Frank Act, once again face the expensive undertaking of digesting complex regulation and implementing compliance frameworks--only now they must do so across multiple jurisdictions. Where rules between jurisdictions are harmonized this burden will be lessened, as standardized rules allow for the use of existing or similar processes across affiliated entities. Where the rules are not standardized, the concept of substituted compliance should be used as broadly as possible by regulators to allow entities in cross-border transactions to satisfy one set of regulatory requirements, and not require them to satisfy the requirements of multiple jurisdictions for a single transaction. At the same time, the United States should use its leverage to ensure that foreign jurisdictions provide exemptions to end-users that are similar to those provided under U.S. law.

The impact of multiple derivatives regulatory regimes is already being felt by end-users, even in the most straightforward, domestic transactions. Just as U.S. end-users may not want to be subject to foreign regulations, non-U.S. market participants, who in the past have provided liquidity to derivatives markets, are opting not to transact with U.S. persons. The result is a fragmentation of what were once deep, global markets into less liquid, more expensive and more volatile, local markets, all of which contribute to higher costs for end-users and their consumers. It is critical that U.S. regulators continue to work closely with their foreign counterparts and move quickly to recognize equivalency and substituted compliance with foreign regulatory regimes when the objectives of foreign regulations are comparable to those under the Dodd-Frank Act and where foreign regulations do not unduly burden end-users.

Finally, the Coalition believes that consistent data and reporting standards across jurisdictions could benefit end-users, regulators and the derivatives markets. The OTC derivatives markets are global and consistency in data requirements will not only help to increase transparency, but will ease the reporting and recordkeeping burdens for multinational companies.

Summary

In summary, the Coalition would like to stress three main points.

First, we support S. 876, which would ensure our ability to use CTUs to execute swaps on behalf of non-financial affiliates. There is no other means for companies to attain the same risk-reducing benefits that the CTU provides when it nets out opposite-way trades and enters into fewer, smaller derivative transaction with bank counterparties. Imposing clearing and margin requirements on CTUs trading on behalf of their non-financial end-user affiliates would be so costly as to eliminate their use, leaving companies with no way in which to replicate the CTU's benefits.

Second, while end-users are now exempt from margining requirements thanks to legislation passed earlier this year, excessive capital requirements being imposed on bank counterparties for over-the-counter transactions with end-users threaten to eviscerate the benefits of that legislation. As the cost of those capital requirements is passed on from banks to end-users, end-users are faced with a decision of whether to forego risk mitigation altogether, to enter into an imperfect hedge or to pay substantially increased hedging costs. With every choice, the end-user faces the possibility of being competitively disadvantaged against foreign competitors where bank regulation has not indirectly undermined the relief to which end-users are entitled under the Dodd-Frank Act.

Third, and finally, international harmonization is of great and growing importance and is particularly relevant for derivatives end-users. For the many that have affiliates located around the world and subject to multiple regulatory regimes, inconsistencies lead to increased costs, confusion and duplication. Even for U.S. entities, duplicative and conflicting regulation impacting the derivatives markets is causing fragmentation of markets and decreasing liquidity. All of these factors could lead end-users to abandon efficient hedging practices or cause them not hedge at all. In your oversight of the implementation of the Dodd-Frank Act, we urge you to encourage U.S. regulators to continue to work with foreign regulatory regimes to recognize equivalence between jurisdictions using an outcomes-based analysis.

Thank you, and I am happy to answer any questions you may have.

COMMODITY MARKETS OVERSIGHT COALITION

An Alliance of Commodity Derivatives End-Users and Consumers

Testimony of Sean O. Cota

Co-Founder, Commodity Markets Oversight Coalition

Before the

U.S. Senate Committee on Agriculture, Nutrition and Forestry

Public Hearing

"Regulatory Issues Impacting End-Users and Market Liquidity"

May 14, 2015

Chairman Roberts, Ranking Member Stabenow and members of the Committee, thank you for the opportunity to testify on the impact of Commodity Futures Trading Commission's (CFTC) regulations on derivatives end-users. My name is Sean Cota and I am delivering testimony on behalf of the Commodity Markets Oversight Coalition (CMOC). Along with other leaders in the energy, transportation, agricultural and manufacturing sectors, I helped to establish the CMOC in August of 2007.[1] Since then, the CMOC has been an advocate for secure, transparent and accountable commodity futures, options and swaps markets. We appreciate the committee's commitment to working with derivatives end-users as it moves forward with CFTC reauthorization.

Background

The CMOC is a non-partisan alliance of industry groups and other organizations that represent commodity-dependent American businesses, end-users and consumers. Our core members are the end-users who transact business in these physical commodities, and seek to

[1] Originally founded as the Energy Markets Oversight Coalition, it changed its name to the Commodity Markets Oversight Coalition in early 2009.

make sure these markets service us - the customers for whom they were created. Our members rely on functional, transparent and competitive commodity derivatives markets as a hedging and price discovery tool. As a coalition we favor policies that promote market stability and confidence; prevent fraud, manipulation and excessive speculation; and, in general, preserve the interests of bona fide hedgers and American consumers.

I first testified before the United States Senate eight years ago as President and co-owner of a family-owned and operated energy company that distributes home heating fuels, motor fuels and biofuels throughout greater Vermont. One of my main roles at the family company was the management of its hedging operations. Hedging is extremely important to heating oil and propane marketers. In addition to broader volatility factors including the price of oil and natural gas, they are exposed to seasonal fluctuations and spikes in demand associated with extended periods of extreme cold and other types of inclement weather. Our industry hedges in order to better protect our business and consumers from risks associated with these commodities and to offer the most stable and affordable prices possible.

Perspectives on Dodd-Frank

Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (or simply, the Dodd-Frank Act) in order to address the opacity and dysfunction in the derivatives markets that both caused the financial meltdown and the unprecedented (and unwarranted) spike in commodity markets. While the law is imperfect, Title VII of the Dodd-Frank Act represents a significant victory for consumers and small businesses, especially for those that hedge. We encourage the Congress to use CFTC reauthorization to build upon key reforms that have led to more competitive, transparent and functional markets and increased confidence among market participants and commodity-dependent businesses.

Title VII of the Dodd-Frank Act expanded the CFTC's jurisdiction from just the futures markets to the more than $700 trillion or more (notional value) over-the-counter swaps markets.[2] By comparison the total World Stock Market Cap is only $63 Trillion.[3] It also completely restored CFTC oversight to so-called "exempt commodities" such as energy and metals. These reforms have had a profoundly positive impact on end-users. Since the enactment of the Dodd-Frank Act, the markets have become more stable, transparent and competitive. Some commodities have seen a decline in volatility of 40 percent or more since 2010. This has bolstered the confidence of market participants, including those I represent.

Thanks to the Commission's implementation and enforcement of vital new trading rules and cooperation with exchanges, self-regulatory organizations and overseas counterparts, the CFTC is now the "cop on the beat" policing fraud, manipulation and abusive trading practices. Consider for example that penalties imposed by the CFTC have increased from $100 million to $1.8 billion over the last five years. CFTC Chairman Massad recently announced that the agency has obtained $2.5 billion in sanctions year-to-date in 2015, which is ten times its current annual budget."[4] This should be considered as Congress weighs the requested funding increase for the Commission, which our Coalition fully supports and is discussed later in this testimony.

Congress also required that the CFTC impose speculative position limits across all commodities in the futures and swaps markets. This provision was supported by CMOC

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[2] Source: Testimony of CFTC Commissioner Timothy Massad before the U.S. House of Representatives, Committee on Appropriations, February 11, 2015.
[3] Source: http://www.aei.org/publication/global-stock-rally-world-market-cap-reached-record-high-in-november-and-is-back-above-pre-recession-pre-crisis-level
[4] Source: CFTC

members and other like-minded end-user groups and commodity-dependent industries as a prophylactic measure to help minimize wild price swings in the price of commodities and, importantly, to prevent market manipulation. We understand that Commissioners are currently negotiating the details of a final rule and we look forward to reviewing it. While many groups representing bona fide hedgers and commodity-dependent industries have some concerns about the specifics of the proposed rule, nearly all of them are supportive of meaningful limits on speculative trades. We hope the concerns of commercial end-users can be adequately addressed and that the CFTC can move forward with the rule in the coming months.

Please note, however, that our Coalition strongly opposes the "conditional spot month limit" included in the December 2013 proposed rule. We understand that many in Congress, both Republicans and Democrats, share our concerns regarding this proposal. The conditional spot month limit would allow a trader to hold a cash-settled position in a given commodity that is up to five times the spot month limit, or 125 percent of deliverable supply. We have submitted comments to the CFTC in strong opposition to this proposal as it could increase price volatility and open the door to manipulation in the cash-settled markets. This would jeopardize market convergence, increase hedging costs and result in market uncertainty for commodity-dependent businesses and consumers.

We are also concerned with a suggestion that the CFTC cede its authority to set speculative position limits and issue bona fide hedge exemptions to the commodity exchanges. While exchanges play an important role in providing a safe and secure platform for transactions between market participants, we must remember that most are publically-traded, for-profit entities. As such, they benefit from higher trading volumes and a large number of market participants and therefore have an incentive to make positon limits voluntary (or at the least very

high) and to allow for broad hedge exemptions that may include purely speculative trades. This proposal runs contrary to the intent of Congress, which is that the CFTC – not the exchanges or self-regulatory organizations – be tasked with the responsibility to set position limit levels and define who should be eligible for bona fide hedge exemptions. Congress should watch developments closely and take action as necessary to ensure that this intent is preserved.

CFTC Reauthorization

As the Committee moves forward with new legislation to renew the CFTC's authorizing statute (the Commodity Exchange Act), the CMOC recommends the following:

- Provide Greater Protections for Customer Funds. Several of my peers in the downstream petroleum industry were victims of the collapse of MF Global - their accounts were frozen and in some cases their market positions were jeopardized. As the committee is well aware, the agriculture sector was particularly affected by this crisis. The CFTC and the exchanges should be commended for their efforts to strengthen consumer protections and prevent a repeat of "MF Global." The committee should support these efforts by including robust customer protections in CFTC reauthorization.
- Reinforce Congressional Intent Regarding End-users. In enacting the Dodd-Frank Act, Congress did not intend for many of its rules and regulations to adversely impact bona fide end-users of commodity derivatives. The committee would be justified in reinforcing this Congressional intent in the CFTC reauthorization bill. However, the CMOC cautions against inadvertently creating new loopholes or regulatory exclusions that might benefit financial institutions and other large market participants by weakening exemptions meant only for bona fide hedgers, or by allowing them to trade overseas without comparable oversight.

- Study into High-Frequency Trading and Autonomous Computerized Trading. In response to the "Flash Crash" and other events in the securities and futures markets, Congress should require a broad study into the role of new trading technologies and practices, including and especially those that utilize automated (and increasingly autonomous) computerized trading programs. This study must include an examination of the cyber-security and national security implications of such technologies and activities, their impact on the commodity markets (including market volatility), and whether or not they could (intentionally or unintentionally) disrupt or manipulate futures and swaps markets.
- Increase Penalties for Fraud and Manipulation. The previous reauthorization in 2008 strengthened antifraud provisions and increased civil monetary penalties for manipulation from $500,000 to $1 million per violation. As a matter of course, these penalties have become insignificant when compared to the overall profits of large market participants and have become part of the "cost of doing business." The committee should take a "zero tolerance" approach to such behavior. We urge you to include in reauthorization an increase in fines and penalties for fraud, manipulation and other severe violations.

CFTC Funding

The CFTC is no longer a small "backwater" agency that regulates niche financial markets. As mentioned, it now regulates financial markets with a notional value that is many hundreds of trillions of dollars in size, are utilized by commodity-dependent business to hedge and to "discover" prices for essential commodities and that, as evidenced by recent events, affect the lives of every single American. The CFTC must do all of this despite limited resources, an unprecedented expansion of its responsibilities under the Dodd-Frank Act, constantly evolving markets, and ever-changing trading practices and technologies. Congress must therefore provide

the CFTC with the $322 million requested for Fiscal Year 2016. These funds are necessary to conduct market surveillance, develop initiatives to guard against cyber-attacks and cyber-terrorism, and to protect market participants and the broader public from fraud, manipulation and excessive speculation.

Conclusion

Five years ago, Congress passed a new law empowering the CFTC to ensure transparency and provide greater security and integrity to markets that our businesses depend on for hedging and price discovery and that affect the lives of every American. This law and related regulatory initiatives are not without their flaws, including concerns that bona fide hedgers may be inadvertently captured by rules and regulations meant for large market participants such as financial institutions. We believe the CFTC has the existing authority to remedy these concerns and if not, Congress would be right to address them in forthcoming reauthorization. However, at the same time, it is essential that the spirit and intent of the original law be upheld if not strengthened. We look forward to assisting Congress in this regard as the process moves forward.

Thank you again for the opportunity to appear before you today. I would be happy to answer any questions you might have and look forward to providing further input as the Congress continues the process of CFTC reauthorization.

APPENDIX I – ENDORSING ORGANIZATIONS

Airlines for America
American Trucking Associations
Colorado-Wyoming Petroleum Marketer Association
Connecticut Energy Marketers Association
Florida Petroleum Marketers Association
Fuel Merchants Association of New Jersey
Gasoline & Automotive Service Dealers of America
Institute for Agriculture and Trade Policy
Louisiana Oil Marketers & Convenience Store Association
Maine Energy Marketers Association
Massachusetts Energy Marketers Association
Montana Petroleum Marketers & Convenience Store Association
National Association of Oil & Energy Service Professionals
National Association of Shell Marketers
National Family Farm Coalition
National Farmers Union
National Latino Farmers & Ranchers Trade Association
New England Fuel Institute
New Mexico Petroleum Marketers Association
New York Oil Heating Association
North Dakota Petroleum Marketers Association
North Dakota Propane Gas Association
North Dakota Retail Association
Oil Heat Council of New Hampshire
Oil Heat Institute of Long Island
Oil Heat Institute of Rhode Island
Organization for Competitive Markets
Petroleum Marketers & Convenience Store Association Kansas
Petroleum Marketers & Convenience Stores of Iowa
Petroleum Marketers Association of America
Public Citizen
Rancher-Cattlemen Action Legal Fund (R-CALF) USA
Vermont Fuel Dealers Association
West Virginia Oil Marketers and Grocers Association

APPENDIX II – BIOGRAPHY

Sean Cota has nearly 40 years of experience in the downstream petroleum industry including more than 17 years as President of one of the most successful retail home heating and motor fuel businesses in northern New England. Cota has previously served as a member of the CFTC's Energy and Environmental Markets Advisory Committee. He is a member and past-Chairman of the Petroleum Marketers Association of America (PMAA) and New England Fuel Institute (NEFI), which together represent marketers that serve more than 8 million households, and who own or distribute to over 100,000 convenience stores or gasoline stations. He has served as a board member and First Vice Chairman of the National Oilheat Research Alliance (NORA) and National Association for Oilheat Research & Education (NAORE). Mr. Cota is a founding member of the Commodity Markets Oversight Coalition (background can be found in the introduction to this testimony). He has been interviewed or quoted in various media, including CNBC, CBS Evening News with Katie Couric, 60 Minutes, MSNBC, Platt's, WUSA-TV, USA Today/Gannett Media, Bloomberg News, The Financial Times, Reuters, ABC News, Oil Price Information Service (OPIS), The Wall Street Journal and various publications in the oil, gas, biofuels and home energy industries. Prior to this hearing Cota has testified on derivatives market oversight before the United States Senate three times, the House of Representatives twice and the Commodities Futures Trading Commission four times.

Mr. Cota is a graduate of Kimball Union Academy and Wilkes University, where he received a Bachelor of Science in Business with a concentration in marketing. He is a native of Bellows Falls, Vermont where he raised his two children, both now attending college. Mr. Cota retired from his family business in 2011 and is now an independent consultant for the industry that he has served and fought for all of his life.

TESTIMONY
OF
TERRENCE A. DUFFY
EXECUTIVE CHAIRMAN & PRESIDENT
CME GROUP INC.
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY

Hearing on CFTC Reauthorization
May 14, 2015

Good morning Chairman Roberts and Ranking Member Stabenow. I am Terry Duffy, Executive Chairman and President of CME Group.[1] Thank you for the opportunity to offer our views on the future of the Commodity Futures Trading Commission ("CFTC" or "Agency"). As this Committee considers reauthorizing the Agency, I would like to highlight five critical issues, specifically as they relate to end-users who participate in CME's markets: position limits, European Union ("EU") equivalency standards, the supplemental leverage ratio, customer protections, and Agency funding.

Position Limits

Perhaps no other post-Dodd Frank rulemaking has been more controversial than the Agency's position limits proposal. The Agency currently is considering public comments on rules that were re-proposed at the end of 2013. Despite a total of over four years of public comments, four notices of proposed rulemakings, and one final rule that was vacated by a federal court, the industry is still awaiting answers to some of the most fundamental questions regarding how a federal position limits regime under Dodd Frank will function.

Significantly, the currently-proposed bona fide hedging exemption would force a dramatic step back from historical market practices by disallowing many reasonable commercial hedging strategies. There is no evidence that Congress intended for the Agency to make it more difficult through position limits rules for farmers, ranchers, and other commercial end-users to hedge their price risks. By limiting the exemption to a rigid and narrow list of enumerated hedges, the Agency's proposal threatens to inject considerable risk into commercial operations. Rather than refuse to give commercial end-users the latitude to continue using reasonable commercial hedging practices for fear that a few bad actors could abuse the system, the Agency should rely

[1] CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

on its anti-evasion powers to enforce the limits. CME supports the CFTC allowing exchanges to administer non-enumerated hedge exemptions that meet the statutory criteria. This approach would alleviate the Agency from needlessly tying up its limited resources responding to requests for non-enumerated hedge exemptions by instead relying on the system that currently is in place today. Exchanges have the most direct experience administering hedge exemptions tailored to real world commercial end-user business operations and this experience has never been cited as having created a problem in need of the Agency's current proposed solution.

Several other critical points for end-users remain in flux. We encourage this Committee to carefully consider the following issues:

- Limits for physical delivery and cash-settled "look-alike" contracts should be equal for the same underlying commodity. The proposed conditional limit exemption for cash-settled contracts threatens to drain liquidity away from the physical delivery markets to the cash-settled markets during the spot month as contracts approach delivery, thus causing harm to the price discovery process and opening the door to potential market misconduct. The Agency should not seek to artificially tip the scale in favor of cash-settled markets and thus increase the risk of possible price manipulations or distortions. Neither outcome would serve the long-term interests of end-users by sacrificing market integrity for liquidity.

- It remains to be seen which deliverable supply estimates the Agency will use as a baseline for setting federal spot-month limits. CME continues to advocate for using the most up-to-date deliverable supply estimates that are available from a physical delivery market. To date, CME is the only U.S. exchange to have provided the Agency with updated deliverable supply estimates for the core referenced futures contracts that would be covered by the Agency's re-proposal, including last month when it submitted a second updated set of estimates. The Agency must identify for the public the deliverable supply estimates it will use prior to finalizing any federal limits and require all exchanges to use those same estimates for purposes of establishing exchange-set limits. Only by using the most current deliverable supply estimates can the CFTC ensure adequate liquidity for end-users while avoiding undue risk of price manipulations or distortions.

- Consistent with past policy, the Agency should not impose spot month limits based on an absolutist approach to the 25% of deliverable supply formula across all referenced contracts. No sound economic theory or analysis supports such a uniform approach. Rather, the Agency should use 25% of deliverable supply as a ceiling and work with the exchange(s) listing the physical-delivery benchmark contracts to set the federal spot-month level below this ceiling on a contract-by-contract basis, based upon the unique market characteristics of each commodity that is traded.

- Position accountability limits should apply in lieu of hard limits outside of the spot month for non-legacy agricultural commodity derivatives. Consistent with statutory requirements, CME has long supported imposing hard cap limits in the spot month as is necessary to prevent price manipulations and other distortions. However, nothing in the Commodity Exchange Act or any legislative history forecloses the possibility of using the more flexible position accountability approach in the out months as an appropriate

alternative to federal hard cap limits. To the contrary, the Commodity Exchange Act authorizes it to adopt a position accountability regime as a form of limit more "appropriate" for balancing the four enumerated statutory interests. Such an approach would better serve market integrity and protect the price discovery process in the out months when diminished liquidity can severely increase the cost of hedging for end-users. Exchanges have successfully relied upon accountability levels for decades to safeguard against market congestion and abusive trading practices. Based on this experience, exchanges are well positioned to partner with the Agency to administer a federal position accountability program, thus preventing any further drain on the Agency's limited resources.

EU Equivalency Standards

Among the most critical issues facing the Commission today is the potential for the United States to be denied status as a country whose regulations are equivalent to Europe's. CME operates futures exchanges, clearinghouses and reporting facilities in the U.S. and United Kingdom, and our U.S. futures products reach over 150 jurisdictions across the globe. Cross-border access is a core part of our global business strategy. CME has long been an unabashed supporter of mutual recognition regimes that (i) eliminate legal uncertainty, (ii) allow cross-border markets to continue operating without actual or threatened disruption, (iii) afford U.S.-based and foreign-based markets and market participants equal flexibility, and (iv) promote a level playing field. Historically, both the U.S. and EU have mutually recognized each other's regulatory regimes to promote cross-border access.

Recently, however, the European Commission has taken a different approach. Under European law, U.S. clearinghouses and exchanges – like CME – must first be recognized by European regulators in order to be treated the same as EU clearinghouses and exchanges. The European Commission is conditioning its recognition of U.S. derivatives laws as equivalent to European law on demands for harmful regulatory changes by the U.S. that would impose competitive burdens on U.S., but not EU, clearinghouses and exchanges, and would harm both U.S. and EU market participants. This refusal to recognize U.S. derivatives laws as equivalent is already having a negative impact on liquidity in our markets by creating trading disincentives and barriers to entry. As a result, diminished liquidity leads to higher hedging costs for commercial end-users in the U.S. and ultimately higher commodity prices paid by U.S. consumers.

After more than two years of negotiation and delay, the EU still has refused to grant U.S. equivalence. Since his arrival at the CFTC, Chairman Massad has been a tremendous leader in working toward a solution that avoids market disruption and affords U.S. and foreign-based markets equal flexibility. Yet, the EU continues to hold up the U.S. equivalence determination over the single issue of differing initial margining standards for clearinghouses. The specific U.S. margin standards in question are an important component, but not the only component, of a robust regulatory structure under the CFTC's oversight. And even considering just this component of the margin standards, the U.S. rules generally require equal, if not more, margin to be posted with clearinghouses to offset exposures than is the case under the EU rules. We applaud Chairman Massad's effective testimony on this issue before the European Parliament last week. Nonetheless, the European Commission has thus far insisted that the U.S. accept EU margin requirements. As Chairman Massad recently stated, "[The CFTC has] offered a

substituted compliance framework for clearinghouse regulation which was [the European Commission's] principal concern. I believe there is ample basis for [the European Commission] to make a determination of equivalence, and I hope that they will do so soon."

By contrast, the European Commission recently granted "equivalent" status to several jurisdictions in Asia, including Singapore, which has the same margin regime as the U.S. Treating the U.S. as not equivalent when the European Commission has deemed the same margin requirements equivalent in Singapore illustrates clearly the hypocritical and inconsistent position the European Commission is taking.

In stark contrast to the EU approach, U.S. regulations currently allow European-based futures markets full access to U.S. market participants. Today, a foreign board of trade may provide direct electronic access to persons located in the U.S. by registering with the CFTC as a Foreign Board of Trade ("FBOT"). The CFTC grants FBOT status if it finds that the board of trade and its clearinghouse are subject to comparable regulation in its home jurisdiction. Although the CFTC has not yet approved all FBOT applications, it has granted no-action relief to several foreign boards of trade with pending FBOT applications, permitting them to continue to access U.S. market participants without disruption until the CFTC completes its review of the FBOT applications.

The European Commission's discriminatory approach to U.S. access to EU markets is creating significant competitive disadvantages for U.S. markets and the participants that use those markets. Without an EU recognition of equivalence, U.S. clearinghouses will not be able to clear EU-mandated derivatives. As market participants prepare for the impending effectiveness of Europe's swaps clearing mandate this fall, already we are seeing European clearing members and other market participants taking steps to consider alternatives to U.S. exchanges and clearinghouses.

This regulatory game of "chicken" also is causing disruptions to U.S. futures markets because, without equivalence, the cost of clearing futures on U.S. markets will increase on December 15, 2015. Under EU laws, non-EU clearinghouses must be recognized by this date as "qualified central counterparties" ("QCCPs"). To be QCCP eligible, the European Commission must determine that the clearing regulations in the applicable non-EU country are "equivalent" to EU regulation. Accordingly, without an EU equivalence determination by December 15, U.S. clearinghouses, like CME, will no longer be treated as "QCCPs" from a capital perspective, thus significantly increasing the costs for European clearing firms to use U.S. clearinghouses. The European Commission has extended this deadline twice now, which has averted disaster but nonetheless continued the current market uncertainty.

The EU's resistance to recognizing U.S. exchanges as equivalent also has driven commercial participants away from U.S. exchanges because their trades are treated as OTC trades unless they are executed on an exchange in an equivalent jurisdiction. Commercial end-users appropriately want to avoid the extra regulatory obligations that come with being deemed "NFC+" entities in Europe—a byproduct of trading a certain amount of non-hedging OTC derivatives—so they are leaving U.S. exchanges or reducing their trading on U.S. exchanges until U.S. equivalence is granted. Make no mistake that a continued decrease in participation in U.S. futures products will

harm both EU and U.S. market participants, reducing liquidity and impeding the ability of farmers, ranchers and other U.S. and EU businesses to conduct prudent risk management.

Insisting that EU margin standards be implemented makes no sense when principles governing margin have already been issued by global standard setters, and have been implemented by the U.S. and other jurisdictions throughout the world. The U.S. should not be the only nation that is required to have identical margin standards to the EU. Time is of the essence. It is imperative that the European Commission take a balanced approach and allow the U.S. and Europe to recognize each other's regulatory regimes, including margin standards, equally—and soon. We appreciate Chairman Roberts' recognition of this crucial issue and wholeheartedly echo the concerns that were raised in his letter to Treasury Secretary Lew in March.

If the U.S. continues to be excluded from the European marketplace, the CFTC has many tools at its disposal to deny the generous access to U.S. markets that foreign boards of trade and clearinghouses now have. Indeed, it would be entirely logical for the CFTC to terminate the no-action relief under which FBOTs in Europe are currently operating until the EU recognizes U.S. derivatives regulations as equivalent and U.S. clearinghouses as QCCPs. I hope this does not prove necessary, but all options must be considered. We urge this Committee to take any and all appropriate actions to support the CFTC's position and reach a solution as soon as possible.

Supplemental Leverage Ratio

One of the pillars of the G-20's commitment to reforming derivatives markets was to transition standardized OTC swaps to the centralized clearing model that futures contracts have traded under in the U.S. for decades. To complement this risk-reduction initiative, the Federal Reserve, in consultation with the Basel Committee on Banking Supervision, last year proposed a Supplemental Leverage Ratio rule intended to limit the amount of leverage that the largest banking organizations can hold on their balance sheets. By keeping balance sheet leverage low, regulators seek to further mitigate systemic risk in the event of a default, including for a bank that is a clearing member of a central clearing counterparty such as CME. The Supplemental Leverage Ratio, however, could have the unintended effect of costing end-users up to five times more to clear trades than it currently costs due to clearing members passing along the cost of the additional capital they must hold to stay within the limit imposed by the ratio. These excess capital costs have already contributed to the decision by some clearing members to exit the market altogether, thus concentrating risk among a smaller pool of central counterparties. Higher clearing costs and fewer clearing members in turn would only exacerbate—not mitigate—the risks central clearing is intended to address.

The Supplemental Leverage Ration's main flaw is that it fails to allow clearing members to net segregated margin held for a cleared trade against the clearing member's exposure on the trade. By law, clearing members cannot use segregated margin to add leverage to the clearing member's balance sheet. Instead, the segregated margin can only serve to offset the exposure a clearing member has on a trade through its guarantee of the trade provided to the clearinghouse. Accordingly, the only real exposure a clearing member has on any trade is the amount of the guarantee to the clearinghouse that exceeds the amount required to be posted to the clearing member as segregated margin (whether by law or by the clearing member as a term of doing business). CME appreciates the steps Chairman Massad has taken recently to address this issue

with prudential regulators in the U.S. such that end-users do not find themselves priced out of cleared derivatives markets.

Customer Protections

SRO Structure

CME continues to reject calls to dismantle the system of self-regulatory organization ("SRO") oversight that has governed the U.S. futures markets for decades. Today, the SRO construct no longer consists solely of a single entity governed by its members regulating its members; rather, exchanges, most of which are public companies, oversee the market-related activities of all of their participants—members and non-members—subject to corollary oversight by the CFTC and National Futures Association ("NFA"). An exchange's daily, hands-on administration of compliance and market surveillance programs for its markets provides a unique level of expertise that the CFTC alone is not equipped to have. This is not to suggest that hard lessons have not been learned in recent years and there is no room for improvement. To the contrary, CME, along with the NFA and other exchanges, has buttressed its systems over the past two years to better detect and deter another MF Global or Peregrine Financial situation from occurring to the financial detriment of farmers, ranchers, and other commercial end-users who rely on robust customer protections for their livelihood.

The financial incentives of SROs also benefit the safety and soundness of the markets which they oversee. Effective SRO regulation is necessary to ensure that an exchange clearinghouse that is required to have "skin in the game" does not have to tap into these reserve funds in the event of a member default, which would in turn harm shareholders. To accomplish this, exchanges devote substantial resources to their self-regulatory responsibilities. CME alone spends more than $40 million annually carrying out its regulatory functions, which includes employing over 200 financial regulatory, IT, and surveillance professionals to monitor its markets and detect financial misconduct before it occurs.

Residual Interest

CME remains fully committed to protecting Futures Commission Merchants ("FCM") customers against the full range of wrongful FCM misconduct that may result in loss of customer funds. In 2012, the CFTC proposed a rule that, under a phased-in schedule, would have required an FCM to maintain *at all times* a sufficient amount of its own funds ("residual interest") in customer-segregated accounts to equal or exceed the total amount of its customers' margin deficiencies. As noted in prior testimony, no system exists to enable an FCM to continuously and accurately calculate customer margin deficiencies in real time. The net result would be that either FCMs would be forced to post their own collateral into customer accounts, or customers would be forced to over-collateralize their margin accounts at all times. Neither outcome constitutes an efficient use of capital and would effectively render derivatives markets prohibitively expensive and unusable for end-users.

We applaud the CFTC for moving away from the "at all times" requirement and further eliminating in March the automatic acceleration in 2018 of the posting deadline to a time occurring earlier than 6:00 pm the day of settlement. Last Congress, this House passed a

Reauthorization Bill that would codify a provision to permanently establish the residual interest posting deadline at the end of each business day, calculated as of the close of business the previous business day. CME again supports the inclusion of such a provision in any Reauthorization Bill considered by the Committee during the current Congress.

Agency Funding

The White House's FY 2016 budget proposal requested a $72 million increase in Agency funding over the current fiscal year. The Administration also signaled continued support for legislative efforts to fund the Agency's budget through "user fees" assessed on transactions that the Agency oversees. While CME supports sufficient funding for the Agency to carry out its critical legislative mandates, we do not support securing this funding through the imposition of what amounts to an additional tax on the backs of America's farmers, ranchers, and other end-users who hedge commodity price risks. As we all know, American consumers ultimately are the ones to pay the higher price when it costs more for commercial end-users to hedge.

In order to fully fund the CFTC at the requested level, the Administration's proposal mistakenly assumes that a user fee will not chase trading volume away to lower cost jurisdictions. This assumption is unrealistic, particularly in an age of electronic, interconnected markets where participants can and will shift their business. As financial reform legislation continues to be implemented around the world, CME is concerned that ample reasons already exist to support the flight of liquidity from U.S. markets overseas. Less liquidity at home will lead to a diminished price discovery process and increased hedging costs for end-users. Now more than ever, we believe it would be shortsighted for Congress to artificially tip the scale in favor of other jurisdictions by imposing a transaction tax to fund the CFTC.

Conclusion

We appreciate the Committee's consideration of the views expressed in this testimony. Please note that the issues discussed herein represent only a handful of the most important points CME believes the Committee should address in reauthorizing the CFTC. We stand ready to assist the Committee as a resource in finalizing legislation that protects and strengthens the liquidity, fairness, and integrity of our markets for ranchers, farmers, and other commercial end-users.

Testimony of Chairman Timothy G. Massad before the
U.S. Senate Committee on Agriculture, Nutrition & Forestry
Washington, DC
May 14, 2015

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.

- Increased oversight of major market participants

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.

- Oversight of Swap Dealers and Margin for Uncleared Swaps

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.

- Responding to Market Developments

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.

Testimony of Jeffrey L. Walker

Chief Risk Officer, Alliance for Cooperative Energy Services Power Marketing LLC

before the Committee on Agriculture, Nutrition and Forestry of the U.S. Senate

Washington, DC

May 14, 2015

Chairman Roberts, Ranking Member Stabenow, Members of the Committee, thank you for inviting me to testify today on the regulatory burdens impacting energy industry end-users and market liquidity.

My name is Jeff Walker, and I am the Chief Risk Officer of Alliance for Cooperative Energy Services, or "ACES" for short. ACES is owned by 21 not-for-profit electric cooperative power supply Members who use energy commodity services provided by ACES to participate in the wholesale electric and natural gas markets. Not only are ACES' Member-owners commercial end-users, but as not-for-profit cooperatives, they are also ultimately owned by the retail electric consumers they serve in 27 states, including Arkansas, Colorado, Georgia, Indiana, Iowa, Kansas, Kentucky, Minnesota, Mississippi, North Carolina, and Ohio. ACES is headquartered in Carmel, Indiana, and has office operations in Minnesota, North Carolina, and Arizona.

U.S. consumers expect some volatility in the price of gasoline they pay at their local gas pumps from week to week, but when consumers get their monthly

electric bill, they've always expected price stability. Consequently, one of ACES' primary goals of helping our Member not-for-profit electric utilities participate in the wholesale energy markets is to manage this price volatility. Sometimes we can use physical transactions to lock in electric energy or generation fuel prices, however, financial transactions must also be used when appropriate to lock in prices, or to manage the price and supply volatility of the commodities our Members use to produce electricity and to serve electricity to consumers.

ACES and its 21 electric utility owners care about the Commodity Futures Trading Commission's (CFTC's) jurisdiction over the energy and energy derivatives markets since CFTC is a regulator of not only the financial markets we use, and financial transactions we enter into, but also because in 2012 the CFTC, much to our surprise, decided to define a portion of our physical transactions as being jurisdictional "swaps" too.[1] I'll address this fundamental jurisdictional issue in a moment.

Since 2010, the Dodd-Frank "Wall Street Reform" Act, and dozens of new CFTC Dodd-Frank-related regulations and interpretations have impacted our energy commodity transactions by adding significant regulatory burden on energy market commercial end-users doing business on Main Street. What's perplexing about this to ACES is that the 2008 financial crisis was not caused by commercial

end-users, by activity in the energy markets, nor even by activity in any physical commodity markets. We see no reason why energy market commercial end-users like electric cooperatives and other utilities should be treated by Congress or the CFTC as though they were the cause of the 2008 financial crisis. I'll take a moment to highlight some of the challenges our electric cooperatives have faced under Dodd-Frank.

- In 2012, CFTC stated in a rulemaking that it would not provide a bright-line test for compliance of its Dodd-Frank regulations because of concerns that doing so would provide a "roadmap for evasion" to market participants.[2] This statement appears to target financial entities who may have exploited regulatory loopholes prior to Dodd-Frank. However, the CFTC's approach has resulted in Dodd-Frank regulations that are vague and ambiguous; making understanding such regulations costly, and compliance by commercial end-users confusing, time-consuming, challenging and – again – very expensive.
- Understanding the do's and don'ts has also meant that each new commercial end-user that wants to become a market participant must piece together a patchwork of dozens of final rules and CFTC interpretations, with dozens of CFTC Staff No-Action Letters that partially delay or waive enforcement for specific categories of companies, or more broadly.[3] The CFTC has not provided

any source that unifies or maps all companion releases together, leaving end-users in doubt about whether they've uncovered all their relevant blind spots throughout CFTC.gov addressing Dodd-Frank regulations.

- In 2012, CFTC imposed an entirely new set of obligations requiring commercial end-users to keep records of pre-trade written communications. Prior to Dodd-Frank, only fiduciaries serving market customers and holding customer funds were burdened this way. This occurs because the CFTC's rules were revised to include certain commercial end-user counterparties or market participants as "members" of trading venues – a status previously reserved for market intermediaries having a fiduciary duty with customers, and holding customer funds.[4] "Member" status now applies to commercial end-users only because a trading venue happened to provide market access directly to its users, as opposed to setting up access through a broker- or intermediary-sponsored scheme. Commercial end-users with direct market access also get saddled with much more onerous and non-standard records retention periods traditionally targeted at customer fiduciaries, not only for pre-trade communications and financial derivative records, but also all of their related physical commodity commercial activity.[5] Even worse, this requirement is not confined to the direct access trading venue. This ambiguous rule may be interpreted to overlay this onerous burden on the entire business dealings of a

commercial end-user's jurisdictional commodity activities. And a commercial end-user can enter this recordkeeping briar patch by making just one transaction on a direct access trading venue.[6]

- Dodd-Frank has brought about an overlap of dual regulation by two Federal agencies: the Federal Energy Regulatory Commission (FERC) and the CFTC, of certain physical commodity transactions[7] - namely "options" that – when entered into are intended to physically-settle, and when exercised, are fulfilled by one party delivering a physical commodity to the other party. Electricity is a unique commodity within CFTC's jurisdiction in that it's <u>not</u> a storable commodity, and yet it's still a physical or "nonfinancial" commodity. Using nonfinancial energy commodity options is essential for electric utilities, given volatile temperatures and consumption patterns in various US regions, the public utility responsibilities for providing reliable electric service in real-time, and the inability to store the commodity. Energy companies don't all trek to Wall Street dealers to meet our local needs. We transact end-user to end-user in regional markets for customized commercial hedges. Consequently, it is our energy markets that are most burdened by CFTC's jurisdictional reach – or overreach – to regulate nonfinancial commodity options where the parties intend physical settlement or delivery.

- Furthermore, it's commonplace in the energy markets to have transactions that combine both jurisdictional and non-jurisdictional attributes together. For example, fixed-volume forward contracts for one energy commodity will often include a layer of volume flexibility, called "embedded optionality" in the same commodity [or a related commodity such as emissions credits or generation capacity] in order to enable a commercial end-user to balance non-storable supply with variable demand in real-time. In 2012, CFTC adopted a complex set of interpretations to determine whether or not such hybrid transactions are jurisdictional as "swaps," in the form of a 7-part test.[8] So if you can thread all 7 needles with a single strand, your hybrid transaction is non-jurisdictional (not a "swap," just a plain old commercial forward contract). But the last needle – the notorious "seventh element" – is a miniature, and extra challenging to thread. More recently, CFTC has proposed to increase the size of the last needle with additional interpretive language.[9] Today, commercial end-users navigate a tangled web of rules, interpretation and guidance, and have debates with each other about whether certain nonfinancial energy transactions between them are subject to an overlap of dual Federal regulation. Many times, the counterparties in a transaction interpret the regulations differently, can't agree, and don't report consistently to CFTC. Each one must assess whose interpretation is right or wrong, whose

reporting is false vs. accurate, and one party or the other could potentially incur significant Commodity Exchange Act liabilities.

- Finally, CFTC's 2013 proposed rule for speculative position limits places more unnecessary burdens on commercial end-users of nonfinancial energy commodities and related swaps.[10] Very narrow "bona fide hedge exemptions" to position limits (that the CFTC believes must be universally applicable to traders and hedgers in all agricultural, oil, natural gas and other physical commodity derivative markets) are proposed by CFTC. Commercial end-users in these very different industries are being told they can only hedge their commercial risks using hedges that are also "bona fide" for traders. They are all viewed as potential market speculators in having to:
    - Monitor their "positions" in a specific commodity on a daily and intra-day basis[11];
    - Provide precise plans in 10-day notices to CFTC before hedge positions can exceed rigidly-set speculative position limits[12]; and
    - Submit reports to CFTC daily and monthly when positions, even aggregated across multiple utility subsidiaries in a consolidated group of commercial companies, exceed such limits[13].

The Commodity Exchange Act clearly permits a more broad and practical exemption from the whole speculative position limits regime for pure hedging

entities that do no speculating, or investing, and CFTC should exercise such broad exemptive authority.[14] For example, the commercial end-user exemption from swap clearing and trading venues adopted by CFTC three years ago could be used as a basis for exempting hedgers or hedging transactions from position limits. That standard is a far less onerous approach for providing hedging relief to commercial end-users, and should also be used by CFTC for position limits.

On the bright side, I commend the CFTC's willingness during the past 11 months to listen to commercial end-users concerns and to start taking account of the need for some changes as we approach the five-year anniversary of Dodd-Frank. I also commend the CFTC for resurrecting the Energy and Environmental Markets Advisory Committee after a five-year hiatus. The energy markets that the not-for-profit Electric Entity (co-op and municipal) members participate in are not just financial trading markets – they are regional markets our Members use to hedge the commercial risks of providing 24/7/365 electric service to their customer/members.

Moving forward, we would like Congress and the CFTC to address the challenges discussed in this testimony, whether legislatively or administratively, to ensure that commercial end-users are not treated like they were the cause of

the 2008 financial crisis. We look forward to providing any information that would be helpful to the Committee as it addresses CFTC reauthorization. We are supportive of reauthorization, but must respectfully request that the CFTC narrow the scope of its rules to remove the significant and unnecessary burdens on commercial end-users.

Thank you for the opportunity to testify. I'd be happy to answer any questions you may have.

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[1] Commodity Options, 77 FR 25320 (Apr. 27, 2012).

[2] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR n. 370, 48298, 48300, and n. 1160 (Aug. 13, 2012).

[3] *E.g. Id.* Commodity Options; CFTC Letter No. 13-08, *Staff No-Action Relief from the Reporting Requirements of § 32.3(b)(1) of the Commission's Regulations, and Certain Recordkeeping Requirements of § 32.3(b), for End Users Eligible for the Trade Option Exemption* (April 5, 2013), available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-08.pdf

[4] Adaptation of Regulations to Incorporate Swaps, 77 FR 66316 (Nov. 2, 2012) (noting 17 C.F.R. 1.3(q)(1)(ii)).

[5] 17 C.F.R. 1.35(a).

[6] 17 C.F.R. 1.35(a)(1) and 1.3(yy).

[7] *Id.* Commodity Options at 25325.

[8] *Id.* Further Definition at 48238.

[9] Forward Contracts With Embedded Volumetric Optionality, 79 FR 69073 (proposed Nov. 20, 2014) (Proposal).

[10] Position Limits for Derivatives, 78 FR 75680 (proposed Dec. 12, 2013) (Proposal).

[11] *Id.* at 75768.

[12] *Id.* at 75831-32 (noting § 150.7(d), (e), and (f)).

[13] *Id.* at 75789-90 (noting § 19.01(a)(1) and § 19.01(b)(2)(i)); at 75832 (noting § 150.7(g)).

[14] CEA section 4a(a)(7); 7 U.S.C. 6a(a)(7).

DOCUMENTS SUBMITTED FOR THE RECORD

MAY 14, 2015

RESEARCH

The Growth Consequences of Dodd-Frank

Douglas Holtz-Eakin

May 6, 2015

Executive Summary

The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was enacted in 2010. It created new agencies and bureaus, changed capital requirements, revamped securitization rules, changed the oversight of derivatives, imposed the Volcker Rule, and had provisions for corporate governance.

This short paper looks at the growth impacts of the banking sector's response to these requirements and the burden of compliance costs. The consequences are significant – roughly $895 billion in reduced Gross Domestic Product (GDP) over the 2016-2025 period, or $3,346 per working-age person. Clearly, such a computation is subject to large uncertainties, but the order of magnitude is instructive.

Introduction

Dodd-Frank was a sweeping reform. It created new agencies and bureaus: the Financial Stability Oversight Council (FSOC), the Office of Financial Research in Treasury, the Consumer Financial Protection Bureau (CBPB), the Federal Insurance Office in Treasury, an Office of Credit Ratings within the Securities and Exchange Commission and others. It revamped securitization rules; changed the oversight of derivatives; changed the prudential standards for risk-based capital, leverage, liquidity, and contingent capital; imposed the Volcker Rule, had provisions for corporate governance, and more. And, in the process of being implemented, it required 398 separate rulemakings that are still not complete nearly five years later.

It is widely perceived that this massive regulatory initiative has generated uncertainty that has harmed lending. It is even more likely that the banking sectors response to these requirements and the burden of regulatory compliance have been an effective tax on the banking sector that has harmed lending, investment and growth. To date, however, there has been little quantitative evidence on the magnitude of these impacts.

This short paper looks at the growth impacts of these requirements and the burden of compliance costs. I modify a standard model of economic growth (the "Solow model") to incorporate these features and then use a parameterized version to estimate the impact.

To anticipate the results, the growth consequences are significant – $895 billion in reduced Gross Domestic Product (GDP) or $3,346 per working-age person over the next 10 years. Clearly, such a computation is subject to large uncertainties, but the order of magnitude is instructive.

A Framework for Analysis

The framework focuses on the links between saving and investment in the economy as a whole. Investment, in turn, drives growth in the capital stock that, when combined with growth in labor, generates growth in output or GDP. Because the goal is to understand

how fast the standard of living rises, the entire exercise focuses on growth in capital per working age individual (labor) and income per person.

The starting point is the observation that national saving finances national investment:

(1) $I = S$

However, the presence of capital and other requirements, compliance burdens and other costs means that not all savings are channeled into productive investments; in part these features serve as a "tax" on intermediation:

(1') $I = S(1-\tau)$

where τ is the effective tax rate. Investment is, by definition the change in the amount of capital, meaning that the growth in the capital stock is given by:

(2) $g_K = I/K = S(1-\tau)/K$

Saving is, in turn, equal to the saving rate (s) times income or GDP (Y):

(3) $g_K = sY(1-\tau)/K$

Using lower case letters to denote capital per worker (k) and GDP per worker (y) yields:

(4) $g_K = s(1-\tau)y/k$

Finally, notice that the difference between growth in the overall capital stock (g_K) and growth in capital per worker (g_k) is the rate of population growth (η):

(5) $g_k = g_K - \eta$

Collecting all these results, the growth rate of capital per worker is generated by:

(6) $g_k = s(1-\tau)y/k - \eta$

The last step in developing the framework is to recognize that the growth of income per worker (g_y) is related to the growth of capital per worker by:

(7) $g_y = \theta g_k = \theta s(1-\tau)y/k - \eta$

where θ is the share of national income earned by capital (as opposed to labor). Equation (7) is crucial to the analysis because it indicates that the change (Δ) in the growth rate when the effective tax on intermediation rises is given by:

(8) $\Delta g_y = -\theta s(y/k)\Delta\tau$

The remainder of this short paper is devoted to exploring the empirical magnitudes implied by the Dodd-Frank burden and equation (8).

Estimating the Growth Impact of Dodd-Frank

The starting point for fleshing out the growth implications of the increased Dodd-Frank burdens is using data from the Bureau of Economic Analysis (BEA) to develop estimates of the share of capital in national income, θ (0.39 in 2013); the gross national saving rate, s (17.6 percent in 2013); and the ratio of output to capital y/k, (=Y/K, 0.33 in 2013). Collecting these results, they imply that the change in the growth rate of income will by roughly 2.3 percent of the change in the effective tax rate on intermediation of saving and investment.

How large is that tax increase? To begin, note that Dodd-Frank is mainly concentrated on the banking sector, while other forms of transforming saving into investment are essentially unaffected. One can think of the overall effective tax rate as a weighted average of the impacts on the banking sector and non-banking financial sectors. For 2013, the BEA shows that fixed investment totaled $2,769.5 billion while the Federal Reserves Flow of Funds data put total bank lending for these purposes at $786.8 billion. Taken together, this suggests that banking has a 28.4 percent share of overall intermediation.

What did Dodd-Frank do to the effective tax rate on banks? Consider, first, the burden of complying with the new regulations. The American Action Forum's analysis of the Federal Register indicates that the cumulative burden (including the market value of paperwork hours for compliance) is roughly $14.8 billion annually. Notice that after-tax income in the presence of the burden is:

(9) $[rL - C - \text{Burden}](1-\tau_B)$

where r is interest on loans (L), C is the cost of acquiring funds and other operations, and τ_B is the tax rate on banks. Suppose that instead of a burden, the same after-tax income was generated by simply raising the tax rate to τ'. Then, by definition:

(10) $[rL - C - \text{Burden}](1-\tau_B) = [rL - C](1-\tau')$

Equation (10) can be re-arranged to yield:

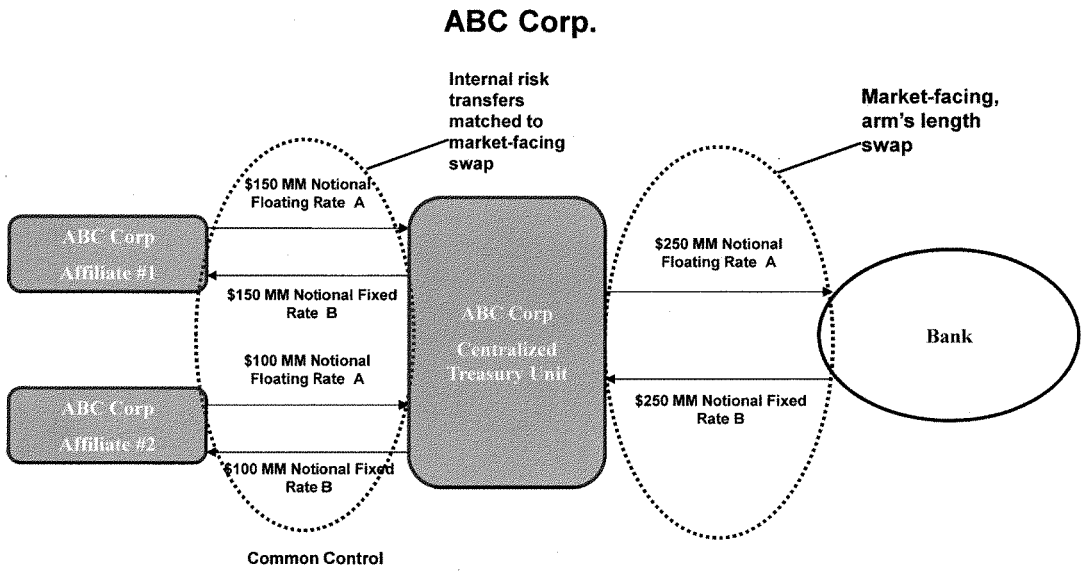
(11) $\tau' = \tau_B + (1-\tau_B)[\text{Burden}/(rL-C)]$

To put some empirical meat on (11), the Federal Deposit Insurance Corporation's (FDIC) Quarterly Banking Profile (QBP) provides information on taxes ($67.5 billion) and net income ($151.2 billion) that permit one to compute an initial tax rate of 31 percent. Using the AAF burden data and (11) yields an increase to 37.8 percent from compliance burdens.

A similar approach can be used to transform the roughly 2 percentage point rise in the leverage ratio of the banking sector (from 7.5 to 9.5 percent) from 2008 to 2014 into a rise in the effective tax rate. The banking sector responded to Dodd-Frank by holding more equity capital, thus require it to have greater earnings to meet the market rate of return – the same impact as raising taxes. In this case, the higher leverage ratio translates into a further increase in the effective tax rate to 40.3 percent, for a total rise of 9.2 percent.

Collecting results, the impact on economic growth is a decline in the per capital growth rate of 0.059 percentage points annually. Is this a big deal? Consider lowering the growth rate in the Congressional Budget Office baseline projections by exactly this amount between 2016 and 2025. The lower rate of economic growth translates into a total loss of $895 billion in GDP or $3,346 for every member of the working age (16 and older) population over those 10 years.

Centralized Treasury Units (CTUs)



COMMODITY MARKETS OVERSIGHT COALITION

An Alliance of Commodity Derivatives End-Users and Consumers

May 18, 2015

The Honorable Pat Roberts, Chairman
The Honorable Debbie Stabenow, Ranking Member
Committee on Agriculture, Nutrition & Forestry
328 Russell Senate Office Building
Washington, DC, 20510

Dear Chairman Roberts and Ranking Member Stabenow:

The Commodity Markets Oversight Coalition would like to thank you for the opportunity to deliver testimony at the hearing entitled "[Commodity Futures Trading Commission:] Regulatory Issues Impacting End-Users and Market Liquidity" on Thursday, May 14, 2015.

As mentioned in the opening remarks by our Coalition's co-founder and witness Sean Cota, we would like that the Owner-Operator Independent Drivers Association (OOIDA) and the Industrial Energy Consumers of America (IECA) be added to the list of organizations endorsing our testimony. These groups would supplement the extensive list of endorsing organizations that can be found under "Appendix I" of our written testimony submitted in advance of the hearing.

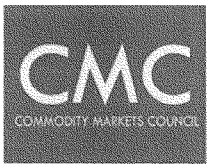
We appreciate your consideration and look forward to working with the committee as it drafts new legislation to reauthorize the Commodity Futures Trading Commission.

Sincerely,

Jim Collura, Co-chair, Commodity Markets Oversight Coalition

QUESTIONS AND ANSWERS

MAY 14, 2015



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Senate Committee on Agriculture, Nutrition & Forestry
Regulatory Issues Impacting End-Users and Market Liquidity
Thursday, May 14, 2015
Questions for the Record
Mr. Bruce Barber

Senator Thune

1. You provided in your testimony that "Since the passage of Dodd-Frank, many new regulations have been implemented without consideration of the real costs on commodity producers or consumers," and that CMC has provided CFTC and other regulators a great deal of information in an effort to help them understand how your members use derivatives markets to reduce operational risks. Yet despite your efforts in the post Dodd-Frank world compliance costs are up substantially.
   Why is that? Can we assume that CFTC is not paying attention to your requests for clarity and how to comply?

I appreciate the question and opportunity to follow-up on my testimony Senator Thune. I am not in a position to discern the motivation or reasoning behind the CFTC's actions or lack of action.

I can confirm that the regulatory response of the CFTC to Dodd-Frank Title VII has substantially increased the regulatory burden and uncertainty for CMC members who are end users of agricultural and energy exchange traded futures and options for risk management. As I indicated in my testimony, the increased regulatory burden has come in the form of increased record keeping requirements, increased information requests and increased uncertainty in the regulatory environment via no-action relief and a lack of consistency in application of bona fide hedge treatment.

I might add that post-Dodd Frank, the CFTC's newfound regulatory zeal of solutions looking for problems has moved the Commission away from its traditional principles based regulatory structure in favor of a regulatory regime that attempted to account for every possible contingency. The result of this "what if scenario" based regulatory regime is that it ends up harming traditional hedging activity. To directly answer your question, they're paying attention to the wrong things.

The physical markets for agricultural and energy products, and the derivative products used by enterprises to manage risks in those businesses, were functioning appropriately prior to the passage of Dodd-Frank. The regulatory framework already in place for those markets provided robust authority to the CFTC for the investigation and pursuit of activity that might threaten the integrity of the price discovery and risk mitigation functions of the market.

In addition to these increased regulatory costs, the regulatory structures being proposed and implemented by the CFTC post Dodd-Frank will have a negative impact along the entire supply chain for agricultural and energy products including a loss in market liquidity. The CFTC should not be increasing the regulatory burden on the marketplace unless there is an increase in the public good from their efforts. So far, there are no winners in this process.

Senate Committee on Agriculture, Nutrition & Forestry
"Regulatory Issues Impacting End-Users and Market Liquidity"
Questions for the Record
June 3, 2015
Mr. Sean Cota

Question from Senator John Thune

"Commodity markets are supposed to be a place of transparent price discovery that are reflective of real-world supply and demand fundamentals. One commodity market that has recently been in the news is the aluminum contract at the London Metal Exchange. The wait time or 'queue' for aluminum that has been requested for delivery has been as high as 650 days but currently is just above 400 days from the warehouse in Detroit, while the wait at the primary warehouse in Europe is over 470 days. Aluminum end users are currently being charged a premium that is a function of the number of days in the queue multiplied by as much as 54 cents per day per ton. Even the CFTC has referred to these transactions as 'merry-go-round' transactions where metal simply goes into a warehouse to extend the waits.

"As someone who has had experience as a commodity end user in the markets, do these wait times and rents make any sense to you? Is this a functioning market in your view?"

Dear Senator Thune,

On behalf of the Commodity Markets Oversight Coalition (CMOC), its constituent organizations and the industries and consumers they serve, we are grateful for the opportunity to testify on May 14th. We would be happy to answer your question.

You are correct. Transparent price discovery for essential commodities such as energy and metals is vital to the growth and competitiveness of many U.S. businesses and industries, including those represented by CMOC. For this reason, it is important that Congress provide the Commodity Futures Trading Commission (CFTC) with the tools and resources necessary to protect hedgers and other commodity-dependent businesses from fraud, manipulation and abusive trading practices. It is vital that the CFTC enact appropriate measures, such as speculative position limits, to prevent unwarranted volatility and ensure that prices are reflective of real-world supply and demand. It is equally important that the committee continue to hold the CFTC accountable when it fails to adequately perform these duties.

I am very concerned with what is happening in the aluminum markets. Large banks, hedge funds and other financial institutions dove head-long into physical commodities, including aluminum, in the years following the financial crisis. When prices for aluminum tanked after the stock market collapse, large banks and their affiliates used cheap money from the Federal Reserve discount window to buy up the metal, hoard it in LME-licensed warehouses and sell futures contracts for delivery at higher prices. This arrangement had major implications for consumers of aluminum, who were subjected to an artificially constrained market and long waits for delivery at unjustified prices.

Speaking from experience as a petroleum marketer, if I had to wait more than 400 days for delivery of motor fuel, heating oil or propane, our family business would not have survived very long. The same is true for any business or industry represented by CMOC. For example, imagine if an airline had to wait more than a year for delivery of jet fuel or a baker for delivery of wheat? For any end-user to have to wait more than a few days for a contract to be fulfilled and the commodity delivered is far outside the norm and completely unacceptable. It is even more troubling that aluminum end-users are being forced to pay a premium for the warehousing of this product during this time.

The issues being experienced by aluminum end-users have widespread implications. Aluminum is a vital commodity that is used far beyond the beverage industry. Consider, for example, that some manufacturers of commercial motor vehicles (CMVs), which are vital to my industry, are increasingly turning to aluminum and aluminum alloys to help increase fuel efficiency. This will be essential not only for CMVs but also automobiles and light trucks as the administration moves forward with tougher efficiency standards. As you can see, a dysfunctional market for any commodity can have widespread implications for many industries, businesses and consumers.

The committee should continue to monitor developments closely and work with aluminum end-users on appropriate measures to remedy these issues. While the CFTC does not have direct regulatory authority over the LME, Congress should encourage Chairman Massad to continue to monitor these issues closely, continue to consult aluminum end-users, and work closely with its overseas counterparts on actions that might be taken to resolve this issue.

We also encourage you to inquire into the status of a Federal Reserve proposal that may restrict bank activities in markets for physical commodities. Discussions at the Fed and in Congress about the possibility of new limits bank involvement in physical commodities has already forced several large banks to sell-off their commodities operations. For example, about six months ago, Goldman Sachs announced it would sell-off its metals-warehousing unit to Switzerland-based Reuben Brothers. You will recall that Goldman had come under Congressional scrutiny for alleged manipulation of aluminum prices in recent years.

Thank you again for the opportunity to testify and to answer your question. I can be reached by phone at (802) 380-1571 or by email at sean.cota@seancota.com if you have additional questions or would like to discuss these issues further.

Sincerely,

Mr. Sean Cota
On behalf of the Commodity Markets Oversight Coalition

Senate Committee on Agriculture, Nutrition & Forestry
Regulatory Issues Impacting End-Users and Market Liquidity
Thursday, May 14, 2015
Questions for the Record
Mr. Terrence A. Duffy

Senator Thune

1. Mr. Duffy, how do you believe that recently finalized bank capital regulation will affect the already shrinking pool of clearing members who facilitate customer margin posted to your clearinghouse? Do you believe these banking rules are at odds with the requirements of the Commodity Exchange Act that require bank-affiliated clearing brokers to segregated customer margin from their own funds?

Yes. Bank capital regulations, in particular the Basel III Supplemental Leverage Ratio rule, are likely to accelerate the reduction in the number clearing members and the availability of the risk mitigation benefits of central clearing to end customers by unnecessarily increasing the costs to clearing members and driving them out of the US market. While the Basel III bank capital regulations have laudable goals of reducing systemic risk through heightened capital requirements for banks and bank affiliates, the end result of this rule and the other bank capital regulations is to undermine the goals of Congress to expand the risk mitigation benefits of central clearing to those in need of hedging and price discovery for their commercial exposures. Surprisingly, the Supplemental Leverage Ratio rule (one of the many new bank capital regulations) is directly at odds with the requirements of the Commodity Exchange Act that (1) client margin be strictly segregated from clearing member and clearing house funds at all times and (2) investment of client margin is subject to significant restrictions (including that it must always be segregated, and only limited investments are permitted). In fact, not only are clearing members significantly restricted in their treatment of customer margin, but the majority of customer margin actually gets passed on to the clearing house, which results in the margin being completely outside of the clearing member control.

Despite these clear regulatory restrictions, the Supplemental Leverage Ratio rule does not permit banks or bank affiliates to offset their cleared derivatives exposures on behalf of their customers with the segregated margin posted by those customers, based on the Basel Committee's mistaken rationale that banks and bank affiliates have the ability to use customer margin for purposes other

than to offset the cleared derivatives exposure of those customers. Furthermore, the Supplemental Leverage Ratio rule's calculation measure causes commodities such as agriculture and energy to be the most expensive asset classes. As a result, the rule unnecessarily increases costs for bank-affiliated clearing members and their customers, and the customers that suffer the greatest costs are the end-users engaged in commercial hedging activity.

The failure of the Basel Committee to appropriately account for the customer margin segregation requirements of the Commodity Exchange Act has already resulted in some clearing firms significantly increasing the fees they charge customers, ceasing to provide clearing services to certain customers, and having active discussions about leaving the customer clearing business altogether. Unfortunately, we expect these trends to gain momentum unless the Leverage Ratio rule problem is resolved to appropriately allow customer margin offset where the margin has been segregated in accordance with the requirements of the Commodity Exchange Act. We strongly urge regulators to take steps to amend or clarify this rule in order to avoid clearing member concentration and reduced customer access to central clearing.

2. **Mr. Duffy, in the last few years there have been a number of reports of problems with how the market for aluminum is functioning. I understand that the CME has set up a competing contract for aluminum. Could you please address for me what some of the market forces are in that contract and what rules the CME uses for delivery from your warehouses?**

The primary problems with the functioning of the Aluminum market have centered around warehousing and the inability to load out the metal in a timely fashion. At the CME, we have always believed that strong warehousing and delivery rules are critical for a well-functioning futures contract. Whether it be our agricultural warehouses or our metal warehouses, the obligations of the warehouse have always been clearly defined. These rules have been designed to address and prevent long queues by having daily load out requirements, as well as stopping rent payment obligations if the load out requirement is not adhered to by the warehouses. Additionally, all warehouses must consent to Exchange jurisdiction, including the Exchange arbitration process, prior to being approved as a warehouse. Having transparency and fairness to the entire delivery process has always been a cornerstone for CME Group physically delivered contracts.

Senate Committee on Agriculture, Nutrition & Forestry
Public Hearing: Regulatory Issues Impacting End-Users and Market Liquidity
Thursday, May 14, 2015
Questions for the Record

The Honorable Timothy Massad, Chairman
Commodity Futures Trading Commission

Chairman Pat Roberts

1. The Prudential Regulators and CFTC recently re-proposed rules for margin requirements for un-cleared swaps. These rules would limit collateral types for variation margin to cash-only. This deviates from the original proposed rule, and international standards that rejected a cash-only approach for margin. The Federal Reserve was part of the International Committee that formed those standards. What was the rationale for adopting a cash-only approach for variation margin? What impact would this cash-only approach have on the broader derivatives market and financial system if other jurisdictions instead follow international standards that allow for a broad range of collateral types to be used for margin?

Response: As you know, Dodd-Frank requires the CFTC to consult with the prudential regulators regarding rules on margin for un-cleared swaps and, to the maximum extent practicable, establish and maintain comparable requirements. In the course of discussing the proposed rules with the prudential regulators, it was noted that currently variation margin is paid in cash for most trades between dealers, which trades constitute more than three quarters of the swaps to which the rules would apply. As noted in the Federal Register release in which these rules were proposed, a cash requirement—at least on trades between dealers-- would be consistent with ongoing industry initiatives to improve standardization and efficiency in bilateral markets and to reduce differences between the bilateral and the cleared markets. We have received a number of comments, however, from financial end users such as insurance companies stating that a cash requirement would be very costly for them. CFTC staff is working with our colleagues at the Prudential Regulators on a way to craft final rules that are responsive to these comments while continuing to promote efficiency.

2. The margin requirements for un-cleared swaps propose that the new requirements regarding variation margin go into effect December 2015, with no phase-in period. For many buy-side investors, these changes differ materially from their existing documentation with dealers. In proposing the December 2015 implementation date, were buy-side impacts taken into consideration and whether an accelerated implementation date could be achieved market-wide?

Response: In March of this year the staff of the CFTC joined in a decision of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions to extend the international implementation schedule to provide for (i) a nine-month delay in the start of implementation from December 2015 to September 2016 and (ii) a six-month phase-in for variation margin from September 2016 through March 2017. Staff expects to propose this delayed implementation date, which will address these market participant concerns, to the Commission when it finalizes the rule.

3. Is the Commission concerned that lowering the swap dealer de minimis level would result in fewer counterparties, and leave end-users with the choice of only a few banks in this role? Will the Commission pledge to not lower the swap dealer de minimis level from its current $8 billion without new rulemaking to give end-users and the public the opportunity to comment?

Response: The Commission staff is currently working on a report on the *de minimis* threshold and related topics, which will contain extensive data on the market. Staff will publish a preliminary version of this report later this year, and will solicit public comment on the methodology and findings in the report as well as on a variety of related topics, including the effects on the market if the *de minimis* level were changed. The notice and comment process and final report will be completed well in advance of December 31, 2017, which is the date when the level would change absent Commission action. This process will thereby provide data and analysis to the Commission that will inform any action it deems appropriate.

4. When the CFTC originally made public utilities "special entities," and thus limited the dealing threshold of their counterparties to $400 million, the utilities complained that they could not find counterparties and the CFTC eventually raised the threshold to $8 billion. Will they face the same problem if the de minimis level is lowered 60% to $3 billion, leading to more counterparties exiting the swaps business?

Response: Public utilities are "special entities" as that term was defined by Congress in the Dodd-Frank Act. Because public utilities are special entities, their counterparties were subject to the lower *de minimis* threshold applicable to persons who deal with special entities generally under the Commission's swap dealer definition as originally adopted. Based on concerns raised by utility special entities regarding the limited availability of counterparties, and given the level of experience that utility special entities have with the commodities that are referenced by the utility operations-related swaps that they enter into, the Commission amended its regulations so that this lower threshold effectively did not apply with respect to such utility companies and utility operations-related swaps.

As noted previously, Commission staff is currently working on a preliminary report, which will be published for public comment, that will consider the underlying policies of swap dealer regulation and the *de minimis* threshold as well as available swap market

data that informs those considerations. This report will provide the Commission with data, analysis and public feedback as it determines what to do.

5. The London Metals Exchange (LME) has taken certain steps to address the persistence of queues in aluminum warehouses within its system. Will the warehouse reforms being implemented by the LME reduce regional premium levels? Can you provide an update regarding progress on the steps LME has taken as it waits for the CFTC to return to its Foreign Board of Trade Application?

Response: The Commission believes that LME's actions can reduce queues in the physical market. This, in turn, should help ensure that prices and premiums reflect the supply-demand dynamic. With respect to the steps LME has taken in order to reduce queues at aluminum warehouses, most of the items included in the LME's original consultations have been implemented. Among others: the Linked Load-In/Load-Out Rule (LILO) was implemented February 1, 2015, with further improvement to be implemented on August 1, 2015; since May 12, 2014, the per-warehouse queue length report has been published on the LME website; LME now publishes a Commitments of Traders report and has created a Physical Market Committee; and a revised information barrier policy has been in effect since January 2015. Changes to the Warehouse Agreement to provide the LME specific powers to address behavior that creates or maintains queues were implemented April 1, 2014, and changes to address orderly functioning of the market and the reporting of inducements were implemented June 1, 2015 (some provisions are effective from January 1, 2016). Also effective on June 1, 2015, were amendments to LME policies and procedures that include the adoption of a new definition of load-out directed at the potential for "Merry-Go-Round" transactions. The LME is currently reviewing responses to a Discussion Paper published March 2, 2015, that addresses, among other things, LME powers to cap or stop rent in queues and free on truck (FoT) rates. The CFTC will continue to monitor the LME's efforts to reduce queues.

Senator Stabenow

1. In a March, 2015 letter, the CFTC's Division of Market Oversight notified the London Metal Exchange that it would defer the LME's foreign board of trade application, and "will not make any recommendation to the Commission at this time." The letter suggests that the deferral is in part a result of queue issues at LME-licensed warehouses, including a warehouse in Detroit, MI. Will the CFTC seek to resolve the warehouse queue issue before approving LME's FBOT application? Has the LME's recent effort at reforming its warehouse regulations reduced queue times? Do you believe queue times will fall in the future as a result of the new LME warehouse regulations?

Response: The deferral of the review of LME's application for registration is, in large part, a result of queue issues at LME-licensed warehouses, particularly the warehouse in Detroit. The CFTC would expect the queues to be reduced before approving LME's application for FBOT registration (LME's goal is that the delivery wait time not exceed 50 days). LME's efforts at reforming its warehouse policies and regulations during the past year have resulted in reduced queue times at the Detroit Metro warehouse of from 683 days as of the end of April 2014 to 406 days as of the end of April 2015. The CFTC continues to ask questions and will continue to monitor LME's efforts to reduce the queue.

2. This Committee has heard from end users, clearinghouses, and clearing members that new banking capital requirements do not accurately consider how segregated customer margin is treated by existing Commodity Exchange Act and CFTC regulations, more specifically that segregated customer margin cannot be used to leverage a bank. Can you provide information to this Committee regarding the conversations you have had with banking regulators regarding how the current banking capital requirements may unintentionally create more risk by increasing costs for end users, including agricultural businesses and manufacturers? Additionally, has further consolidation among futures commission merchants and clearing members been considered as a potential adverse consequence of this banking capital requirement?

Response: CFTC staff has discussed with banking regulators both domestically and internationally our concerns regarding the unintended consequences of the treatment, in the context of the bank capital leverage ratio, of margin for exposures, arising from derivatives cleared on behalf of clients. Among those consequences are increasing costs for end users, on the one hand, and potential reduced availability of clearing services, on the other. Staff is hopeful that these discussions will result in alternative approaches that will properly balance the important objectives of both the leverage ratio as well as central clearing of derivatives.

3. Since foreign exchange swaps are not currently subject to clearing or trading mandates, do you believe the Commission's regulatory treatment of swap execution facilities that trade only foreign exchange swaps creates an incentive for market participants to not engage in foreign exchange swap trading on SEFs? If some market participants are in fact not engaging in foreign exchange swap trading on SEFs because of current CFTC regulatory treatment, is the Commission considering changes, including mandating clearing of foreign exchange swaps, in order to increase participation and market transparency?

Response: In 2012, the Department of the Treasury determined that the definition of "swap" in Section 1a of the Commodity Exchange Act does not cover a "foreign exchange swap" (77 Fed. Reg. 69,694 (Nov. 20, 2012)). Consequently, no CFTC swap clearing or trade execution requirement, under Section 2(h)(1) and (8) of the Commodity Exchange Act, could apply to a foreign exchange swap. However, the Treasury Department's 2012 determination recognized that the CFTC's swap definition covers a "foreign exchange non-deliverable forward" ("NDF"), which the CFTC distinguished from a foreign exchange swap (77 Fed. Reg. 48,208 (Aug. 13, 2012)).

The Commission held an advisory committee meeting in fall 2014 at which time the issue of whether to propose a swap clearing requirement for NDFs was discussed. There were diverse views on whether such a requirement was desirable at this time. Many participants felt the market was not ready for such a mandate. The Commission has also been in contact with European regulators regarding possible coordination of any such requirement. This year, the European Union decided to delay such a swap clearing requirement for the time being. For these reasons, the Commission is not currently considering a clearing requirement for NDFs, but it may revise the issue in the future. A trade execution requirement for NDFs could not take effect until a related swap clearing requirement first took effect.

Notwithstanding the absence of such a trading mandate, counterparties to NDFs have the option of executing such transactions on a trading platform such as a SEF or DCM or bilaterally The Commission has recently taken several steps to improve its SEF trading framework in order to enhance trading, and we will continue to review the current SEF rules to determine whether they should be modified further.

4. One of Dodd-Frank's primary goals was to move the trading of standardized, cleared, and liquid swaps onto CFTC registered swap execution facilities. Several end user groups have commented to this Committee that the Commission should mandate anonymous trading in central limit order books, versus a post-trade name disclosure practice. Is the CFTC considering whether post-trade name disclosure may be concentrating liquidity to a few market participants and generally narrowing liquidity on SEFs, which may ultimately lead to unintended market disruptions and volatility?

Response: The Commission is looking at the question of whether the trading of certain swaps should be required to be anonymous. We are evaluating the practice of name give up with respect to trades taking place on a central limit order book that are then immediately cleared. A variety of different views have been expressed on this issue, including with respect to potential effects on liquidity of taking (or not taking) action. There are also different views on what should be the role of the Commission in this area. In addition, with respect to whether the Commission should take action, while some parties have argued that no individual SEF will move to prohibit the practice of its own initiative and that instead the Commission should intervene and prohibit the practice, others believe the Commission should leave it up to market participants.

Senator Grassley

1. Failure to Convey the Inspector General's Budget Comments to the President: The Inspector General Act of 1978 requires the Agency to include with its President's Budget submission any comments the IG. It is my understanding that in CFTC's President's Budget Requests for Fiscal Years 2014, 2015, and 2016, the CFTC has altered the Inspector General's budget request and yet not afforded the OIG the opportunity to comment on the changes – despite this being a clear requirement of the IG Act.
Please explain why the CFTC is not following the requirements of the Inspector General Act of 1978.

Response: The CFTC strives to comply with all requirements set forth in the Inspector General Act of 1978, 5 U.S.C. App. I, as amended, (IG Act), and works in good faith with the CFTC Office of the Inspector General (OIG) to present the CFTC OIG's annual budget to the President in compliance with Federal budget standards and the budget presentation recommendations that the CFTC OIG receives in periodic peer reviews.

As set forth in the IG Act, the annual President's Budget Request must "include in each budget of the United States Government submitted to Congress . . . any comments of the affected Inspector General with respect to the proposal if the Inspector General concludes that the budget submitted by the President would substantially inhibit the Inspector General from performing the duties of the office." 5 U.S.C. App. I § 6(f)(3)(E).

In both FY 2015 and FY 2016, the President's Budget for the CFTC requested an amount for the CFTC OIG that was equal to or exceeded that which was submitted by the CFTC OIG to the Commission. Therefore, the CFTC did not ask the CFTC OIG to confirm that a budget request that was either equal to or exceeded their initial request would not "substantially inhibit [them] . . . from performing the duties of [their] office," 5 U.S.C. App. I § 6(f)(3)(E).

In FY 2014, prior to my taking office, the CFTC IG submitted a budget request for 7 FTE, which constituted an increase of one FTE and an amount for operating expenses. The request for an additional FTE was not included and the adjustment was not noted in the President's Budget Request. While I was not here at the time and cannot speak to the specifics of this situation, the CFTC should provide OIG with the opportunity to comment consistent with the requirements of the IG Act.

Going forward the CFTC and CFTC OIG have developed an improved process for the FY 2017 budget cycle that includes increased communication, clear deadlines, and a defined period set aside for the CFTC OIG to review the CFTC's submission of its section of the President's Budget and to provide any comments for inclusion in the President's Budget before it is sent to Congress. I believe that this improved process will enhance compliance with the requirements of Section 6(f)(3)(E) of the IG Act.

2. Delays in issuing policies: It has come to my attention that administrative policies, including important policies on issues such as workplace violence, and incident response procedures for improper disclosures of personally identifiable information, have been pending for more than a year in some instances. The bulk of the delay appears to rest with the Office of General Counsel. What steps are being taken to address these processes and reduce the backlog and ensure these vital policies are approved in a timely manner?

Response: CFTC policies are developed by knowledgeable professionals with subject matter expertise across the Commission, in most cases within the Office of the Executive Director (OED). Policies are initially developed by the sponsoring office. In some cases, this process takes an extended period of time taking into account the complexity of the issues addressed in the policy as well as the resource constraints facing the agency. After initial development, the policies are then circulated to the Office of General Counsel (OGC) which begins an interactive and iterative process of discussion and revision with the sponsoring office and with others within the agency. The OGC and the OED work collaboratively to develop the most effective, comprehensive, and legally sound policies for the CFTC. To further streamline the policy review process, CFTC's OGC and OED are working together to implement a CFTC-wide policy development and approval process. This new process will be overseen by a Policy Program Manager who will be charged with ensuring the policy process is executed efficiently, high priority policies are identified, and that progress on policies is tracked closely from inception to completion to avoid any unnecessary delays. Finally, CFTC is in the process of hiring additional staff within OGC to assist with policy review.

3. Leased space: For about a year, I have been questioning the excess office space at the CFTC office in Kansas City. CFTC entered into a long-term lease for space to accommodate 78 staffers but only 33 employees currently work there. Today, over 60 percent of the office space remains vacant. If current staffing levels remain the same, CFTC will spend over $3.6 million over the ten year lease for vacant office space, based on one hundred percent occupancy. What steps have been taken to get rid of excess office space in Kansas City and other CFTC offices? And what steps have been proposed for the near future?

Response: During my first month as Chairman, I visited the Kansas City office to observe for myself the usage of space that we had leased. Shortly thereafter, I directed our staff to notify the landlord in Kansas City that we wanted to give up some of our leased space. We next consolidated our use of space in Kansas City from two floors to one floor, so that the excess space would be more attractive to another tenant.

Consistent with the terms of the current lease, the return of excess office space in Kansas City requires the consent of the landlord. We have therefore formally requested that the Kansas City landlord seek other tenants for the Commission's excess and unoccupied space. As requested, the landlord has been actively marketing the space, but has yet to complete a deal with a new tenant and has not released the CFTC from its contractual

obligation to pay rent for its current excess space. The CFTC will continue to work with the landlord on opportunities for resolving this issue. Finally, the CFTC is also evaluating whether potential reductions in leased space at its other office locations would be appropriate.

What, if any, policies have been put in place to prevent the CFTC from entering into similar wasteful leases in the future?

Response: The CFTC continues to adhere to the *Statement of General Principles and Practices Pertaining to the Award and Administration of CFTC's Office Space Leases,* which was finalized on February, 11, 2011. The CFTC's current leases expire between March 2021 and September 2025, and therefore we do not foresee entering into new leases for several years.

Senator Heitkamp

1. We want to provide as much relief to end-users as possible, but at the same time we recognize that strong safeguards are necessary to help eliminate fraud and bad actors. There have been several recent CFTC enforcement cases that demonstrate the importance of pre-trade recordkeeping. Could you discuss how Rule 1.35 has been or has not been helpful in recent enforcement cases? Are you able to get the information necessary for prosecution without Rule 1.35? Where would the line be for keeping appropriate amounts of records for end-users without being overly burdensome?

Response: Regulation 1.35 pertains to the records of commodity interest and related cash or forward transactions of registrants, including futures commission merchants, retail foreign exchange dealers, and introducing brokers, and those industry participants who choose to become members of designated contract markets (DCM) or swap execution facilities (SEF). In virtually every enforcement case brought by the Commission against market participants who are subject to the rule, the types of pre-trade records required to be kept under regulation 1.35 include evidence of wrongdoing or lead us to such evidence. Time and time again, such pre-trade records have proven critical to establishing elements of a violation, such as intent or a scheme to defraud.

The Commission's recent benchmark manipulation cases (i.e., LIBOR, FX, and ISDAFix) are but one example of how these types of pre-trade communications can contain evidence of egregious wrongdoing that harm consumers and undermine the markets. In these benchmark cases, traders at banks attempted, through various means (false reporting of market information, trading and coordinated actions with others) to manipulate benchmarks which are critical to the pricing and value of complex financial products. Consumers' mortgages are indexed to LIBOR. Those cases were built on evidence of the traders and employees' communications concerning the steps to take to manipulate the setting of the benchmarks, their motives, i.e, to profit by benefiting their derivatives and cash trading positions, and at times to celebrate their successes. These pre-trades chats, IMS and audio of recorded telephone lines were evidence of the intent to manipulate. *See e.g. In re The Royal Bank of Scotland plc and RBS Securities Japan Limited* (CFTC Feb. 6, 1013). Without this recordkeeping regulation, market participants could decide for themselves which records to maintain – and which to simply throw away. This could significantly impact - and impair - the CFTC's ability to enforce the Commodity Exchange Act and prevent fraud and bad actors.

The Commission has proposed a rule making with respect to Rule 1.35 to address excluding Commodity Trading Advisors (CTAs) and members of DCMs or SEFs who are not registered with the Commission in any capacity from certain of the recordkeeping requirements. While I believe this proposed rulemaking obtains an appropriate balance, I continue to consider whether additional adjustments to the rule should be made with respect to the reporting requirements as they apply to small businesses that are registrants or members of a DCM or SEF, without sacrificing the demonstrated need for surveillance enforcement to have access to these records to protect customers and ensure that the

markets are operating with integrity and free from manipulative, disruptive, and fraudulent forces.

2. In North Dakota, we grow both hard red winter, which is traded on the Kansas City exchange, and hard red spring, which is at Minneapolis, so our producers and companies who purchase their products, have real interest in making sure the market continues to work efficiently for both exchanges. I know the wheat growers commented on the Commission's position limits rule that the proposal could reduce Kansas City and Minneapolis's competitiveness, which could negatively affect our producers in North Dakota. Could you discuss the factors the Commission is weighing on wheat equivalence and how we can make sure our producers aren't negatively affected by a final rule?

Response: For many years, including currently, CFTC Regulation 150.2 has provided wheat equivalence, i.e., the levels of position limits for wheat contracts listed by three Designated Contract Markets (DCMs) have been set at the same levels.

In 2013, the Commission published a notice of proposed rulemaking that solicited public comment on estimated deliverable supply submitted by CME Group for its CBOT and KCBT wheat contracts. On May 13, 2015 (the day before the Senate committee hearing), Commission staff again invited MGEX staff to submit an updated estimate of deliverable supply underlying the MGEX wheat contract.

Commission staff is currently evaluating the CME Group estimates of deliverable supply in the two wheat contracts, as well as comment letters recommending a continuation of wheat equivalence. The Commission will carefully consider continuing wheat equivalence, including the extent that limits serve to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery (spot) month. In addition, the Commission will take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the Act, as well as the policies and purposes of the Act.

Senator Klobuchar

1. As you note in your written testimony, it is common for a large corporation with large non-financial operations to have an affiliate enter into swaps for the company and its subsidiaries. Having one centralized treasury unit makes sense and has been an industry best practice for years. The Commodity Futures Trading Commission recognized the value of this common sense practice by issuing a "no-action letter" last November 2014. I have been working to help provide businesses that rely on a centralized treasury unit more certainty regarding this rule. I would like to work together to find a solution for these businesses. What are the underlying legal issues that companies with affiliates and subsidiaries with centralized treasury units face when trying to apply the end-user exemption? How could these issues be resolved?

Response: The Commodity Exchange Act does not exclude a centralized treasury unit ("CTU") from the swap clearing requirement described in Section 2(h)(1). The "end-user exception" to the swap clearing requirement, under Section 2(h)(7) of the Commodity Exchange Act, only permits an entity *not* covered by the definition of financial entity (Section 2(h)(7)(C)(i)) to elect the exception, and it is commonly understood that a CTU is a financial entity. Section 2(h)(7)(D) would permit a CTU to elect the end-user exception but for the fact that the provision is limited to a CTU that executes a swap on behalf of its non-financial affiliate *as an agent*, whereas a CTU may often execute a swap *as a principal* on behalf of its non-financial affiliate. Since the CFTC's swap clearing requirement took effect in 2013, a CTU has been permitted to elect the end-user exception pursuant to CFTC staff no-action letters (CFTC Letters 13-22 and 14-144). In March and April 2015, CFTC staff advised Senate and House staff on amendments to Section 2(h)(7)(D) that would permit a CTU, executing a swap as a principal on behalf of its non-financial affiliate, to elect the end-user exception consistent with CFTC Letter 14-144. CFTC Letter 14-144 contains several conditions that limit relief to a CTU that executes hedging swaps on behalf of a non-financial affiliate.

Senator Sasse

1. Chairman Massad, my understanding is that the goal of regulating Swap Dealers as entities was to have safeguards in place to ensure that the business dealings with customers were regulated and that sufficient margin and capital stood behind those trades. Yet when looking at the rules that require registration with the CFTC, as well as the Commission's cross border guidance, it seems that U.S. firms who provide liquidity anonymously in centrally cleared and traded swaps would be required to register with your agency in some capacity if they exceed the de Minimis $8 billion threshold, but foreign firms who engage in the exact same activity taking place in the U.S. are not required to register with the CFTC. How does this not put U.S. firms attempting to help the transition of swaps to central clearing and trading at a competitive disadvantage? I'm struggling to understand the distinction given that the activity seems identical.

Response: You raise an important point. In developing its approach to applying its swap dealer *de minimis* counting rules in the cross-border context, the Commission sought to balance its supervisory interest with principles of international comity. Given its strong supervisory interest in all swap dealing activities of U.S. firms, the Commission has taken the approach that a U.S. entity should generally count all of its swap dealing activities toward its *de minimis* registration threshold, regardless of the identity of its counterparty. In recognition of the important supervisory interest a foreign regulator would have over the foreign activities of a foreign entity and in the interest of reducing the potential for conflicts with foreign jurisdictions, however, the Commission has taken the approach that a foreign entity should generally only count its swaps activities with U.S. persons (or guaranteed or conduit affiliates of U.S. persons). The determination that a foreign entity should generally not have to count swaps that are traded anonymously on an exchange and centrally cleared resulted from the practical impossibility of requiring the foreign entity to determine the U.S. person status of the counterparty. Your question also highlights the importance of harmonization of rules globally. Achieving greater harmonization will insure that we have a strong global framework for regulating this market while at the same time avoiding competitive distortions. I am very committed to working with my counterparts at foreign regulatory agencies, as well as through formal and informal international organizations, to further the work of harmonizing derivatives regulations as much as possible. I also think this is an issue that we can look at in the context of the study we are currently doing on the swap dealer *de minimis* threshold.

2. Based on my description in question "1", could you provide me with the total number of foreign firms that engage in this activity who exceed the de Minimis $8 billion threshold and would normally be subject to CFTC registration requirements?

Response: As noted in the answer to question 1, the Commission determined that the practical difficulties of identifying nationalities of anonymous counterparties is difficult and therefore does not require the reporting of such information separately. Accordingly, the Commission does not have directly relevant data that would be needed to answer this question. Of the 104 swap dealers who are registered, we note that 52 are foreign firms.

Senator Thune

1. Mr. Massad, throughout the development of the Dodd-Frank Act there were several Senators on this Committee who expressed concern that global regulatory confusion would ensue if regulations were not well coordinated. Due to the number of regulators around the world necessary to effectuate rational implementation of the complex derivatives provisions, those warnings now seem to be realized. In spite of assurances that global regulators were united, it has become obvious that these regulatory relationships are strained. The CFTC was a first mover in many of their regulations and in particular with regard to cross-border application of your regulations the CFTC issued guidance, rather than formal rulemaking. Why is that?

Response: The Commission had to quickly promulgate rules necessary to implement Title VII, including key provisions that became effective within one year of the passage of the Dodd-Frank Act. This included the rules concerning mandatory clearing, trading, general oversight of major market participants and trade reporting. This timetable was not conditioned on the progress of other jurisdictions in implementing their rules. The agency acted expeditiously to carry out this mandate. In conjunction with these reform initiatives, the Commission issued its guidance and policy statement on the cross-border application of Dodd-Frank's swap provisions and related Commission regulations. Although I was not at the Commission at the time, it is my understanding that the Commission opted for this course in view of the Congressional mandate, the complexity and dynamic nature of the global swap market, and because foreign jurisdictions were not as far along on their swaps reform. I note also that the guidance was finalized after extensive public comment and close consultation with other regulators, foreign and domestic.

Since taking office, I have made cross-border harmonization of swaps regulation a high priority. We are making good progress with regard to margin for un-cleared swaps. The Commission, together with the U.S. bank regulators, has played an active role in encouraging international harmonization and coordination of margin rules. Individual regulatory authorities across major jurisdictions (including the EU and Japan) have since started to develop their own margin rules. The Commission's proposed margin rules are consistent with the standards in the final international framework, and we are in continuous communication with regulators in the EU and Japan as we develop our cross-border margin proposal.

Another important area that has been a high priority under my tenure is central clearinghouse recognition and regulation. As you may know, the Europeans have not yet recognized our central clearinghouses as equivalent. Their law, EMIR, requires not only that our rules governing our clearinghouses meet international standards—which they do—but also that our laws have an effective equivalent system of recognition for clearinghouses located in Europe. We continue to be in dialogue with the Europeans to facilitate their recognition of our clearinghouses. We are making good progress. They have agreed that the Commission's framework of dual registration and cooperative supervision should not be dismantled. And we have agreed to consider changes that would further harmonize our rules with European rules governing these clearinghouses.

This would in turn facilitate their recognition of our U.S. clearinghouses, as well as our exchanges, which they have also not yet recognized.

Also central to our continuing harmonization efforts is the Commission's substituted compliance program. Under this approach, market participants may comply with foreign rules in lieu of compliance with the Commission's rules where the foreign jurisdiction's requirements and oversight are comparable and comprehensive compared to corresponding requirements under the Commodity Exchange Act and Commission regulations. To date, we have issued comparability determinations with respect to the key swap dealer rules of six jurisdictions—the European Union, Japan, Australia, Hong Kong, Switzerland, and Canada. We will continue to look at other jurisdictions' rules as those are finalized.

2. There are concerns about several existing CFTC regulations - what are you doing to make improvements to existing regulations?

Since my time in office, one of my priorities has been to address the concerns of commercial end-users with respect to various rules, to ensure that they can continue to use these markets effectively and efficiently. Below are some examples of these rule changes. Additional examples and details can be found in my testimony before the Committee on pages 3 – 7.

Specifically, we made sure that our proposed rule on margin for un-cleared swaps exempts commercial end-users from this requirement. We amended our rules by approving a change to the swap dealer registration threshold for transactions with special entities so that local, publicly-owned utility companies could continue to effectively hedge their risks in the energy swaps market. The Commission modified one of our customer protection-related rules to address a concern of many in the agricultural community and many smaller customers regarding the posting of collateral, the so-called residual interest rule. In the area of reporting requirements, we proposed to exempt end-users and commodity trading advisors from certain recordkeeping requirements related to text messages and phone calls. The proposal also clarified, in response to public feedback, that oral and written communications that lead to the execution of a transaction need not be linked to records identifying that transaction.

We have also taken a number of actions to improve the swap trading and reporting rules, including changes related to package trades, error trades, confirmations and other matters.

I also note that in accordance with Executive Order 13563, "Improving Regulation and Regulatory Review," the Commission in June 2011 announced a plan to identify and evaluate its regulations to determine whether any should be modified, expanded, streamlined or repealed in order to make the agency's regulatory program more effective. In Phase One of the Commission's plan, staff focused on those of its existing regulations affected by the Dodd-Frank Act. We are currently working on Phase Two of the plan, which concentrates on regulations that were not reviewed as part of the Dodd-Frank effort.

3. The SEC took a different approach and has now twice proposed formal rules to address the global reach of their derivatives regulations. Has the CFTC's controversial move to address cross-border matters through more expedient guidance really resulted in advancing the goals of more transparency and better risk mitigation or rather fostered a regulatory impasse?

Response: Although I was not at the Commission at the time of those actions, I would note that the Commission has engaged in a significant series of rulemakings pursuant to its mandate to regulate swaps under Title VII of the Dodd-Frank Act. As a result of these rulemakings, swaps transactions are being cleared and reported. Trading of swaps on regulated platforms is increasing and transparency and strong risk management are being achieved. And we have increased oversight of key market participants through the registration and regulation of swap dealers and major swap participants.

Since taking office, I have made it a priority to coordinate our activities with the SEC (as well as with other domestic regulators such as the prudential regulators), and I have also focused on cross-border harmonization of derivatives regulation, as noted above.

4. Might your agency consider formal rulemaking to better legitimize global coordination?

Response: Since taking office, I have been doing so. For example, last fall, in connection with our proposal on margin requirements for uncleared swaps, we set forth three possible ways we could apply the rule to cross-border transactions, and we solicited public comment on those options. We are currently evaluating those comments, coordinating with the prudential regulators who must develop margin rules also, and deciding what to do. I expect that we will make a specific proposal on the cross-border application of margin rules and invite another round of public comment on the proposal.

We have also been very active in the development of international standards with respect to margin requirements for uncleared swaps, and we have had regular discussions with regulatory authorities in the EU and Japan in an attempt to harmonize our respective approaches to the margin rules as much as possible, including with respect to basic thresholds, timetables for implementation and other matters. This is an important example of working internationally so that the rules are as similar as possible from the beginning. While there are still some differences in the various proposals, we are working hard to try to minimize those differences, and I am confident the resulting rules will have benefitted from the collaboration.

I expect that our work in co-chairing an international committee on data harmonization may also lead to further proposals for amendments to our rules as well.

5. Mr. Chairman, the Division of Market Oversight recently issued a letter to the London Metals Exchange regarding problems in LME-licensed aluminum warehouses. The CFTC noted that dysfunction in this market, particularly with respect to the length of time aluminum is incentivized to stay in warehouses results in additional costs being charged to

aluminum users. I'd like to enter into the record of this hearing the March 24 letter from the DMO to the LME. The letter basically states that until some issues in this market are addressed, that the CFTC will defer consideration of the LME as a registered Foreign Board of Trade in the US. I support this position and I understand that the London Metals Exchange has been working to modernize its market but has been subjected to litigation in the UK that slowed the progress.

Response: The LME has been working to address queue issues at aluminum warehouses, and such efforts have shown some success - LME's efforts at reforming its warehouse policies and regulations during the past year have resulted in reduced queue times at the Detroit Metro warehouse from 683 days as of the end of April 2014 to 406 days as of the end of April 2015. It appears that the litigation that slowed the progress in addressing warehouse issues has been concluded and the LME is optimistic that queue times will continue to fall in the future, largely as a result of new LME policies and warehouse regulations.

6. Mr. Chairman, is the CFTC willing to work with other regulators in London or other countries to address the dysfunction in this global market?

Response: The CFTC is ready, willing and able to work with regulators in London or other countries to address any global market or regulatory concerns. CFTC staff routinely and frequently coordinates and communicates with other regulators, both on a one-on-one basis and as participants in international organizations such as IOSCO.

7. Are you routinely in contact with the LME itself and its regulators in the UK and Europe on these issues?

Response: The CFTC is routinely in contact with LME and its regulator, the UK Financial Conduct Authority (FCA), on these issues. Since taking office, I have met in person with each of Garry Jones, CEO of LME, and the CEO of the FCA, Martin Wheatley, several times, including in each case this month. CFTC staff is in telephone contact with the FCA and LME frequently, and meet in person periodically.

8. Do you need additional statutory guidance to address these issues – and if so – what would that be?

Response: The CFTC does not need additional statutory guidance at this time to address these issues.

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