Written Testimony of

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Subcommittee on Commodity Markets, Digital Assets, and Rural Development

"Reauthorizing the CFTC: Stakeholder Perspectives"

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Chairman Johnson, Ranking Member Caraveo, and esteemed members of the subcommittee, thank you for the opportunity to appear before you today to discuss reauthorization of the Commodity Futures Trading Commission (CFTC).

I am senior director of financial regulation at the Center for American Progress, an independent, nonpartisan policy institute dedicated to improving the lives of all Americans through bold, progressive ideas, as well as strong leadership and concerted action.

While reauthorization presents an opportunity to assess the funding of an agency and ensure that those financial resources are adequate for the responsibilities Congress has given it, as explained below we strongly caution against using the CFTC reauthorization process to expand the agency's authorities, into areas significantly beyond its current expertise and capabilities.

The CFTC should be reauthorized in order to protect our economy

The CFTC plays a central role in oversight of physical commodities markets which are essential for our economy, including our manufacturing, transportation, and agriculture. And since the enactment of the Dodd-Frank Act and through subsequent rule makings, it has come to play an essential role in overseeing the complex financial products known as swaps, which were at the heart of the 2007-2008 Financial Crisis.

The commission oversees 41 registered entities, including 16 designated contract markets (DCMs), 21 registered swap execution facilities (SEFs) and four provisionally registered swap data repositories.[1] It currently has ten registered derivatives clearing organizations (DCOs), two of which have been designated by the Financial Stability Oversight Council as systemically important.[2] And it regulates five registered DCOs located beyond U.S. borders.[3] The Commission's market participants division oversees the registration and compliance of thousands of derivatives market participants, such as swap dealers, major swap participants, futures commission merchants, retail foreign exchange dealers, introducing brokers, commodity trading advisors, commodity pool operators, floor brokers, and floor traders.[4] In addition, it oversees futures industry self-regulatory organizations, such as the Chicago Mercantile Exchange and the National Futures Association.[5]

Yet, the CFTC is critically underfunded and would remain so even if Congress were to grant all the funding it has requested. Frankly, the agency does not have adequate resources to fulfill its existing mission and statutory obligations.

The challenge with the CFTC is that it has been so chronically underfunded that many important protections and functions that should be performed by the Commission are not today. For example, the Commission does not comprehensively review all DCM rule changes and products to ensure their compliance with the law and the Core Principles. These changes may include changes to market data

[1] Commodity Futures Trading Commission, *President's Budget, Fiscal Year 2025*, March 2024, available at https://www.cftc.gov/sites/default/files/CFTC%20FY%202025%20President's%20Budget_Final_for%20Posting.pdf.
[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] Ibid.

access and costs, trading operations changes, or listing of new products. The rules and processes adopted by the CFTC currently do not allow for adequate Commission or public consideration of these changes now, leading to DCM practices that unnecessarily burden market participants with costs and complexities that are inconsistent with the law and Core Principles.[6]

Other functions that one might expect have also never been done, likely because the target users of the markets it has traditionally overseen have been sophisticated businesses. For example, the agency and the SROs it oversees have never developed or enforced detailed advertising, performance, and fee rules. This stands in stark contrast to the detailed requirements imposed upon brokers and asset managers in the securities markets.[7]

Unfortunately, the inadequate budgeting and staffing at the agency have led to inadequate examinations, leading to several high profile, years-long abuses and misconduct in some of its core markets, such as U.S. Treasury futures and metals futures markets.[8]

The 2007-2008 Financial Crisis is more than 16 years in the rearview mirror. As this committee considers reauthorization of the CFTC, it should remember the details of how the Financial Crisis happened and the devastation of the financial system and the economy that followed. The dangerous combination of deregulation and weakening of regulators' authorities that preceded the crisis led to a collapse of major portions of our financial system and ultimately a lengthy recession. Between 2008 and 2009, the U.S. lost

[6] See, e.g., Letter from Chris Nagy, Healthy Markets Association, to Hon. Heath Tarbert, CFTC, December 11, 2020, available at https://healthymarkets.org/wp-content/uploads/2020/12/CME-Historical-Data-12-11-2020-4.pdf.
[7] FINRA, Rule 221:. Communications with the Public, available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/2210. Notably, in those markets, registered securities exchanges are not soliciting orders from the public for transactions or generally making claims related to asset performance.
[8] See, e.g., Abhishek Manikandan and Michelle Price, "JPMorgan to pay $920 million for manipulating precious metals, Treasury market," Reuters, September 29, 2020, available at https://www.reuters.com/article/business/jpmorgan-to-pay-920-million-for-manipulating-precious-metals-treasury-market-idUSKBN26K321/ (reflecting Treasury and metals market manipulations lasting from 2008 to 2016).

7.6 million jobs, and it took until 2014 for employment to recover to pre-crisis levels.[9] And from 2008 to 2013, more than five years later, gross domestic product (GDP) per capita remained below the 2007 level.[10] Economists at the Federal Reserve Bank of San Francisco have estimated that the long-term effects of the Financial Crisis led to a lifetime income loss per capita in present discounted value terms of about $70,000 (in 2017 dollars).[11] Wealth gaps between the middle class and wealthy Americans worsened significantly all because the rules that placed guardrails on risk-taking had been gutted and the agencies responsible for overseeing the financial system had been weakened.

This committee should also keep in mind that, since the crisis, the markets overseen by the CFTC have become larger, faster, more interconnected, and more retail in focus. In other words, the demands on the CFTC are already greater than they have ever been.

My colleagues Marc Jarsulic and Lilith Fellowes-Granda at the Center for American Progress recently estimated the present-day costs of a repeat of the Great Recession.[12] They found that a 2007-scale financial shock today would result in 8.7 million people losing their jobs by 2026, and employment would not recover to current levels until 2031.[13]

[9] Marc Jarsulic and Lilith Fellowes-Granda, "Project 2025 Would Allow Financial Disaster To Bolster Wall Street's Bottom Line," Center for American Progress, July 1, 2024, available at https://www.americanprogress.org/article/project-2025-would-allow-financial-disaster-to-bolster-wall-streets-bottom-line/.

[10] Ibid.

[11] Regis Barnichon, Christian Matthes, and Alexander Ziegenbein, "The Financial Crisis at 10: Will We Ever Recover?", Federal Reserve Bank of San Francisco, August 13, 2018, available at https://www.frbsf.org/research-and-insights/publications/economic-letter/2018/08/financial-crisis-at-10-years-will-we-ever-recover/.

[12] Marc Jarsulic and Lilith Fellowes-Granda, "Project 2025 Would Allow Financial Disaster To Bolster Wall Street's Bottom Line," Center for American Progress, July 1, 2024, available at https://www.americanprogress.org/article/project-2025-would-allow-financial-disaster-to-bolster-wall-streets-bottom-line/.

[13] Ibid.

As we all know by now, previously unregulated over-the-counter derivatives played a central role in the Financial Crisis. Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act[14] called for a comprehensive regulatory framework for these derivatives, granting the CFTC regulatory authority over swaps and the Securities and Exchange Commission (SEC) regulatory authority over security-based swaps.[15] Through transparency, business conduct standards, clearing requirements and much more,[16] the framework sought to eliminate or reduce risky practices that led to the crisis, including price opacity, the sale by large firms of credit default swaps with inadequate capital or liquidity to back the trades, practices that undermined the ability to net trades thus increasing counterparty risk, and the commingling of client margins with dealer assets.[17]

By 2021, the CFTC had fulfilled a large part of its initial responsibility to draft implementing rules required by the Dodd-Frank Act.[18] But its job is still not finished. It has a responsibility to continue overseeing swaps and other derivative markets, as well as major market participants. The agency must monitor the markets and market participants for compliance with its existing rules, and impose appropriate disclosure requirements, margin and capital rules, risk management standards, and other safeguards on the firms and products under its jurisdiction. These responsibilities are essential to maintaining the integrity, resilience, and vibrancy of our derivatives markets—and ensure that these markets never again threaten the stability of our financial system or wreak havoc on our economy.

[14] Dodd-Frank Wall Street and Consumer Protection Act, Pub.L. 111-203, July 21, 2010, available at https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf.
[15] Michael S. Barr, Howell E. Jackson, and Margaret E. Tahyar, *Financial Regulation: Law and Policy*, West Academic (St. Paul: 2021) at pp.1265-66.
[16] Legal Information Institute, "Dodd-Frank: Title VII – Wall Street Transparency and Accountability," Cornell Law School, available at https://www.law.cornell.edu/wex/dodd-frank_title_vii_-_wall_street_transparency_and_accountability (last accessed July 2024).
[17] Barr, 2021, at p.1263.
[18] "Final Rules, Guidance, Exemptive Orders & Other Actions," Commodity Futures Trading Commission website, available at https://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/index.htm (last accessed July 2024).

Recognizing the additional responsibilities it had imposed, Congress significantly increased the budget of the CFTC after passage of the Dodd-Frank Act and enacted several increases beyond the rate of inflation over the years since then. The percentage change in the last 5 years—from 2019 to 2024—was 36 percent or 11 percent, when adjusted for inflation.[19] Still, as mentioned above, these amounts are insufficient for the Commission to carry out its existing responsibilities.

For this reason and for other reasons explained below, we strongly encourage Congress to avoid expanding the authority of the CFTC at this time, especially for purposes of authorizing new areas of responsibility that are beyond its current expertise and jurisdiction, such as new authorities relating to digital assets or voluntary carbon credits (VCCs). Expansion of the agency's jurisdiction in such areas may lead to regulatory inefficiencies, the creation of negative market signals and incentives, and general market confusion. More important, it would divert the Commission's resources away from its existing responsibilities, which are so essential to our economy.

My remaining remarks focus on the importance of avoiding inefficiencies, disincentives, and market confusion associated with such expanded authorities.

CFTC authorization should not be expanded for purposes of setting up a special regime for crypto assets or regulating voluntary carbon credits.

Proposals to expand the jurisdiction of the CFTC are often justified on grounds of promoting innovation and the claim that rules to protect investors stifle innovation. But this is not a binary choice: innovation or investor protection. It is possible to have both. The greater risk is not of stifling innovation. The greater risk is unleashing something that puts investors or worse the financial system and the economy

[19] Author's calculations based on actual budget figures in annual White House budget proposals since FY2009, adjusted for inflation using the Employment Cost Index.

at risk. That is what happened prior to the Financial Crisis. In the Commodity Futures Modernization Act of 2000, Congress exempted most over-the-counter (OTC) swaps from CFTC and SEC jurisdiction, allowing the exemption as long as the participants were sophisticated, as defined broadly in the legislation.[20] By 2008, the gross amount of OTC derivatives outstanding had increased by 630 percent, and credit default swaps had increased 100-fold.[21] Financial lobbying played a major role in this state of affairs, which severely undermined regulators' ability to see what was going on and stem the fallout.[22]

This lesson from recent history must guide current debates in which financial market participants seek weaker regulation.

Agricultural markets are so important, and they depend upon the CFTC to ensure that derivatives markets function well and are free of fraud and manipulation. It is important for this committee to understand that expanded authorities of the types the agency has sought would distract it from its foundational responsibilities.

Digital asset regulation

Whatever promise the digital asset industry may hold, we already know for certain that it contains rampant fraud and abuse. Digital assets are promoted by conflicted market intermediaries that are often acting as introducing broker, executing broker, transfer agent, custodian, and more.

If Congress is to develop a new, specialized regime for the regulation of digital assets, ensuring some integrity of the claims made to customers should be a top priority. But, while the CFTC does not

[20] Barr, 2021, at p.1259.
[21] Ibid.
[22] Ibid.

generally have such a regime, the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization that oversees registered securities broker-dealer firms, and the SEC do.

Because there are many registered broker dealers that engage with digital assets, FINRA has already begun to examine issues related to their crypto marketing claims. In particular, in November 2022, as part of a targeted exam, FINRA reviewed over 500 crypto asset-related retail communications by its registered broker-dealer members.[23] It found that over 70 percent of those communications contained potential substantive violations of FINRA's rule on communications with the public.[24] These included, for example, false statements or implications that crypto assets functioned like cash or cash equivalent instruments; comparisons of crypto assets to other assets, like stock investments, without providing a sound basis to compare the varying features and risks of these investments; failure to provide a sound basis to evaluate crypto assets by omitting clear explanations of how crypto assets are issued, held, transferred, or sold; and misrepresenting that the protections of the federal securities laws or FINRA rules applied to crypto assets.

These findings related only to the handful of crypto firms that are also already registered broker-dealers in the securities markets, who would seem to be the most likely to comply with regulatory requirements. It does not include the "native" crypto firms that have declined to make such registrations.

Again, the CFTC and its self-regulatory organization lack comprehensive marketing and sales practices rules like those of FINRA and the SEC. This is just one part of the extensive regulatory framework that the agency would have to develop in order to adequately protect retail investors in crypto. Yet, developing such rules would take years and absorb significant time and energy of the agency, and the rules that

[23] FINRA, "FINRA Provides Update on Targeted Exam: Crypto Asset Communications," January 2024, available at https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/sweep-update-jan2024.
[24] FINRA, Rule 221: Communications with the Public, available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/2210.

would be developed could raise regulatory risk if challenged in court. All of this raises the distinct possibility that such a new CFTC regime for crypto would actually introduce more uncertainty around these assets, rather than creating clarity.

In the 116th Congress, the last time CFTC reauthorization legislation was considered, the draft bill at that time, HR 6197, included provisions that would have provided for the regulation of digital commodities, though the full implications of that language are not clear. The industry has worked with like-minded legislators since then to craft a more detailed regulatory regime under the jurisdiction of the CFTC for digital commodities. These proposals have serious potential ramifications for retail investors, consumers, and the stability of the financial system. Any perceived gaps in the current federal financial regulatory framework as it applies to digital transactions would pale in comparison to the potential negative impacts of these proposals.

The crypto industry has long argued for a special regulatory regime under the CFTC. But the CFTC by design has never focused on retail investors. The commodity laws do not even contemplate the idea of an issuer who is selling to a retail investor; thus, the agency has never had to protect people from the information asymmetry that arises in such situations. The CFTC was created in 1974 to regulate derivatives, which are complex financial contracts that are based on the value of an underlying asset. They are used to hedge against the risk of changing prices in a wide range of industries, but very seldom by retail investors and consumers. Increasingly, derivatives are used for speculation. They are just too complicated, potentially volatile, and risky for retail investors.

By contrast, the SEC—also by design—has focused on protecting retail investors since it was created 90 years ago. It has decades of experience with protecting investors and the public, and it has developed a robust framework of rules for doing so—rules that can and do apply to the vast majority of digital asset transactions. It would be extremely inefficient—and costly to taxpayers and market participants—to create a duplicate investor protection regime for digital assets at the CFTC.

It is also highly likely that authorizing a special regulatory regime for crypto under the CFTC would create negative market signals and incentives, as players in other markets sought to restructure assets and deals to take advantage of the vacuum of rules and capacity to protect retail crypto investors. The industry has defied the SEC rules that already apply to them,[25] and, if the CFTC's jurisdiction over digital assets were expanded, there is no reason to believe that the crypto industry would not resist rules designed to accomplish similar investor and consumer protection goals at the CFTC.

If the CFTC's jurisdiction is expanded to allow it to develop a special regulatory regime for crypto, this would likely provide a veneer of credibility and safety around crypto. This could result in even more harm to retail crypto investors, who may think they are fully protected.

Finally, as alluded to above, the implementation of a comprehensive regulatory regime for digital assets within the CFTC's jurisdiction would be unprecedented in the agency's history, and both the burdens on the agency and the risks to the capital markets could be exceedingly large.

Regulation of voluntary carbon credit derivatives

Voluntary carbon credit (VCC) derivatives pose a different problem. As the responses to the CFTC's proposed guidance for voluntary carbon credit derivatives make clear,[26] the underlying assets—the

[25] Chair Gary Gensler, "Statement on the Financial Innovation and Technology for the 21st Century Act," U.S. Securities and Exchange Commission, May 22, 2024, available at https://www.sec.gov/newsroom/speeches-statements/gensler-21st-century-act-05222024 (last accessed July 2024).

[26] Letter to The Honorable Rostin Behnam, Center for American Progress Comments on Commission Guidance Regarding the Listing of Voluntary Carbon Credit Derivative Contracts, February 16, 2024, available at https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=73324&SearchText=progress.

voluntary carbon credits themselves—cannot readily be traded in a manner that is consistent with the Core Principles.[27]

It is well established that a material percentage of the underlying projects that purportedly give rise to the credits simply do not generate the carbon savings claimed by those who market them.[28] They are not certain and verifiable and thus not fungible enough to ensure that trading in them will be consistent with the Core Principles. It would be similar to an aluminum futures contract being traded despite the warrant for the aluminum being tied to only half of the promised amount, or no aluminum at all, perhaps a small hunk of granite.

Already, the commodity futures markets are occasionally rocked by scandals where it is later revealed that the physical metal underlying futures contracts has disappeared or of improper form or volume. But these cases should be relatively easy to identify and quickly end, given that the actual metal is supposed to be stored at a warehouse that could be quickly and easily inspected. There is no credible way for this verification function to exist either on an initial or ongoing basis for the vast majority of projects claiming some reduction of carbon in the air.

Worse, unlike in the physical commodities markets, where the ultimate purchaser of a contract may take physical delivery and use the metal, for example, that simply does not happen in the VCC markets. The end user in the metals markets very much wants the metal to be of the specified quality and quantity, so

[27] Designated Contract Markets (DCMs), Commodity Futures Trading Commission website, available at https://www.cftc.gov/IndustryOversight/TradingOrganizations/DCMs/index.htm (last accessed July 2024).

[28] See, e.g., Natasha White, "Carbon Offset Gatekeepers Are Failing to Stop Junk Credits," Bloomberg, March 21, 2023, available at https://news.bloomberglaw.com/esg/carbon-offset-gatekeepers-are-failing-to-stop-junk-credits; Patrick Greenfield, "Revealed: more than 90% of rainforest carbon offsets by biggest certifier are worthless, analysis shows," The Guardian, January 18, 2023, available at https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe; and Debra Kahn, "Offsets' promise and peril," Politico, January 1, 2023, available at https://www.politico.com/newsletters/the-long-game/2023/01/20/offsets-promise-and-peril-00078763.

as to be potentially useful. However, there is no such market protection built into VCCs, as the carbon saved is not directly used. To the contrary, many users of VCCs may have incentives to accept exaggerated claims of carbon saved.

The problem cannot be solved by delegating a standard setter, which the CFTC cannot do, or by allowing the accrediting of VCC derivatives contracts by the exchanges, which are equally lacking in the scientific knowledge and capacity to ensure that the underlying assets are certain and verifiable. Under these circumstances, allowing the designated contract markets to approve the listing of voluntary carbon credit derivatives would only result in market confusion and fraud.

VCCs are likely to continue inviting waste and fraud. Unlike carbon credits traded under government cap and trade regimes, by definition VCCs do not involve governments, do not have corresponding government emissions caps, and can be created anywhere in the world, making them nearly impossible to verify and monitor. One recent study found that the vast majority of voluntary carbon credits are not valid.[29] Before carbon credits can form the basis for derivative contracts, there must be an independent, reliable, fact-based entity that verifies carbon emission reductions on a global basis. To date, that does not exist, despite efforts under the auspices of the United Nations.[30]

VCC derivatives should not be listed or traded under the auspices of CFTC authority until there is a clear, consistent, and reliable methodology for creating voluntary carbon credits and establishing their permanence, as well as how to verify, register, and retire credits in a unified global system. Without

[29] Patrick Greenfield, "Revealed: more than 90% of rainforest carbon offsets by biggest cer4fier are worthless, analysis shows," The Guardian, January 18, 2023, available at https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe.

[30] Eklavya Gupte and Agamoni Ghosh, "COP28: Lack of progress on Ar4cle 6 likely to further limit carbon market growth," S&P Global, December 13, 2023, available at https://www.spglobal.com/commodityinsights/en/market-insights/latest-news/oil/121323-cop28-lack-of-progress-on-article-6-likely-to-further-limit-carbon-market-growth

these prerequisites, the most essential terms of a derivative contract based on those carbon credits, the amount of carbon actually being removed and for how long, will not be sufficiently known to form a reliable market that is consistent with the Core Principles.

At the same time, the CFTC should aggressively pursue cases of obvious fraud and manipulation in VCC markets that have impacts on its derivatives markets, including for contracts that have already been identified as being tied to credits that were awarded for fraudulent or erroneous reasons. This should be a significant priority for the understaffed and underfunded examinations and enforcement staff. Again, the agency appears to not have the resources to protect its existing jurisdictions, even though it already has sufficient existing authorities.

To conclude, we strongly support a clean reauthorization of the CFTC, without new authorities, so that the agency can focus on its existing responsibilities to ensure the integrity, resilience, and vibrancy of U.S. derivatives markets.

Thank you again for inviting me to testify today. I look forward to answering your questions.

Biographical information for **Alexandra Thornton**

Alexandra Thornton (she/her) is the senior director of Financial Regulation and a member of the Inclusive Economy team at the Center for American Progress (CAP), an independent, nonprofit policy institute, which she joined in 2014. Her recent work has focused on securities law exemptions, voluntary carbon credit derivatives, capital access for small businesses, climate-related risk disclosures, accounting and auditing standards, capital markets regulation, human capital disclosure, and digital assets regulation. An attorney and former litigator, she left private practice to serve as Tax Counsel to a member of the U.S. Senate Committee on Finance and later as Senior Director of Tax Policy at CAP.

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In accordance with Rule XI, clause 2(g)(5)* of the *Rules of the House of Representatives*, witnesses are asked to disclose the following information. Please complete this form electronically by filling in the provided blanks.

Committee: Agriculture

Subcommittee: Commodity Markets, Digital Assets, and Rural Development

Hearing Date: 07/25/2024

Hearing Title :

"Reauthorizing the CFTC: Stakeholder Perspectives"

Witness Name: Alexandra Thornton

Position/Title: Senior Director, Financial Regulation

Witness Type: ○ Governmental ● Non-governmental

Are you representing yourself or an organization? ● Self ○ Organization

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I am not a fiduciary of any organization or entity that has an interest in the subject matter of the hearing.

Please list any federal grants or contracts (including subgrants or subcontracts) related to the hearing's subject matter that you, the organization(s) you represent, or entities for which you serve as a fiduciary have received in the past thirty-six months from the date of the hearing. Include the source and amount of each grant or contract.

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I have not received any contracts, grants, or payments originating with a foreign government.

Please complete the following fields. If necessary, attach additional sheet(s) to provide more information.

☑ I have attached a written statement of proposed testimony.

☑ I have attached my curriculum vitae or biography.

* Rule XI, clause 2(g)(5), of the U.S. House of Representatives provides:

(5)(A) Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof.

(B) In the case of a witness appearing in a non-governmental capacity, a written statement of proposed testimony shall include— (i) a curriculum vitae; (ii) a disclosure of any Federal grants or contracts, or contracts, grants, or payments originating with a foreign government, received during the past 36 months by the witness or by an entity represented by the witness and related to the subject matter of the hearing; and (iii) a disclosure of whether the witness is a fiduciary (including, but not limited to, a director, officer, advisor, or resident agent) of any organization or entity that has an interest in the subject matter of the hearing.

(C) The disclosure referred to in subdivision (B)(iii) shall include— (i) the amount and source of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) related to the subject matter of the hearing; and (ii) the amount and country of origin of any payment or contract related to the subject matter of the hearing originating with a foreign government.

(D) Such statements, with appropriate redactions to protect the privacy or security of the witness, shall be made publicly available in electronic form 24 hours before the witness appears to the extent practicable, but not later than one day after the witness appears.