Good morning, Chairman Scott, Ranking Member Scott and members of the Subcommittee. Thank you for the opportunity to testify on the reauthorization of the Commodity Futures Trading Commission (CFTC). I am honored to testify alongside my fellow Commissioners Mark Wetjen and Sharon Bowen and provide my perspective on the CFTC’s reauthorization.

I want to first thank the CFTC staff for their hard work and dedication. I also want to thank my fellow Commissioners. It is a privilege to work with them in service to the American people. I believe the CFTC has a new spirit of cooperation and professionalism under Chairman Massad, not only internally within the CFTC, but also externally with other regulators and market participants. Before I continue, I make the standard disclaimer that my remarks reflect my own views and do not necessarily constitute the views of the CFTC, my fellow CFTC Commissioners or of the CFTC staff.

As this is my first appearance before you as a Commissioner, let me briefly say by way of professional introduction that I have been a consistent advocate for practical and effective implementation of the three key pillars of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act):\(^1\) enhanced swaps transparency through data reporting, regulated swaps execution and increased central counterparty (CCP) clearing. My support for these reforms is based on over a dozen years’ of practical experience as a business professional and operator of global marketplaces for swaps trading. I believe that balanced and well-crafted regulatory oversight goes hand-in-hand with vibrant, transparent and competitive markets, a growing US economy and American job creation.

In my first year on the Commission, I have focused on four major issue sets:

I. Commercial end-user concerns;
II. Derivatives trading position limits;
III. CFTC swaps trading rules; and
IV. Cross-border impact of derivatives regulation.

I am pleased by this opportunity to update you on concerns in each of these areas.

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I. **Commercial End-User Concerns**

As a supporter of the Dodd-Frank swaps reforms, I am disappointed that traditional commodity and energy markets and the end-users who depend on them for a variety of uses have been saddled with a range of unintended consequences of implementation of several of the Dodd-Frank reforms. Derivatives end-users were not the source of the financial crisis. That is why Congress undertook to exempt end-users from the reach of swaps regulation. It is our job at the CFTC to make sure that our rules do not treat them as though they were the cause of the crisis.

A. **Proposed Changes to Rule 1.35**

In a number of key areas that I will discuss, CFTC action in the wake of Dodd-Frank in both the futures and swaps markets is overly burdening end-users. For example, in 2012, the CFTC revised Rule 1.35.² The revised rule requires retention of all oral and written records that lead to the execution of a transaction in a commodity interest and related cash or forward transaction in a form and manner “identifiable and searchable by transaction.”³ This recordkeeping must be done (with certain carve-outs) by intermediaries known as futures commission merchants (FCMs), retail foreign exchange dealers, introducing brokers (IBs) and members of exchanges and platforms, known as designated contract markets (DCMs) and swap execution facilities (SEFs).⁴

The revised rule 1.35 has proved to be unworkable. Its publication was followed by requests for no-action relief and a public roundtable at which entities covered by the rule voiced their inability to tie all communications leading to the execution of a transaction to a particular transaction or transactions. End-user exchange members pointed out that business that was once conducted by telephone had moved to text messaging, so the carve-out in the rule for oral communications gave little relief. They pointed out that it was simply not feasible technologically to keep pre-trade text messages in a form and manner “identifiable and searchable by transaction.”

Last fall, I voted against a proposed CFTC rule fix that did not do enough to ease this unnecessary burden on participants in America’s futures markets.⁵ That proposal was a well-intentioned but insufficient attempt to provide relief from unworkable Rule 1.35 requirements. Rather than facilitating the collection of useful records for investigations and enforcement actions, the rule imposes senseless costs that fall especially hard on small FCMs that serve as intermediaries between American farmers and manufacturers and US futures markets and members of exchanges that are not required to register with the CFTC.

Many of the small and medium-sized FCMs assist America’s farmers and producers to control their costs of production. Unfortunately, today we have around half the number of FCMs serving our farmers that we had a few years ago. FCMs, particularly smaller ones, are being squeezed by the current environment of low interest rates and increased regulatory burdens. They are barely breaking even. Just this past Thursday, April 9, another FCM exited the futures markets when US-based Jefferies Group announced the sale of its storied Bache Futures.

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³ Id. and 17 C.F.R. 1.35(a).
⁴ Id.
⁵ Records of Commodity Interest and Related Cash or Forward Transactions, 79 FR 68,140 (proposed Nov. 14, 2014).
business to French bank Société Générale. Like many FCMs, Bache Futures had been struggling with falling fees and high operating costs, including costs of regulatory compliance.

The requirement to retain all written communications that lead to the execution of a transaction in a commodity interest or related cash or forward transaction under Rule 1.35 effectively requires commercial end-users that are exchange members to retain every communication connected to a cash market transaction because their cash market transactions may eventually become part of the net exposure of a hedged portfolio. This expanded oversight of the cash market activity of commercial end-users was not called for by Dodd-Frank and discourages exchange membership. It was recently reported that end-users have avoided doing business on Nodal Exchange, a Virginia-based, non-intermediated futures exchange that specializes in electric congestion contracts, due to the Rule 1.35 requirements.

We should not be further squeezing American agriculture and manufacturing with increased costs of complying with rules such as 1.35, if we can avoid it. The stated purpose of the Dodd-Frank Act was to reform “Wall Street.” Instead, we are burdening “Main Street” by adding new compliance costs onto our farmers, grain elevators and small FCMs. Those costs will surely work their way into the everyday costs of groceries and winter heating fuel for American families, dragging down the US economy. I am supportive of both regulatory and legislative changes to ensure this does not happen.

B. End-Users Captured As “Financial Entities”

Another example of an unreasonable burden placed on end-users is the CFTC interpretation of the Dodd-Frank definition of “financial entity.” It has led to the inadvertent capture of many energy firms as “financial entities.” As we have seen, imposing banking law concepts onto market participants that are not banks and that did not contribute to the financial crisis is not only confusing, but also adds more risk to the US financial system. It has the practical effect of preventing certain energy firms from taking advantage of the end-user exemption for clearing or from mitigating certain types of commercial risk. Again, let us not punish market participants who played no role in the financial crisis.

C. Swap Dealer De Minimis Level

Requiring that the Commission take a vote before a major shift in its regulations takes effect seems like a basic tenet of proper administrative law. However, in the CFTC’s final rule defining who would be captured as a “swap dealer,” the Commission abdicated this responsibility. Instead, the rule allows the “de minimis” threshold of $8 billion dollars of swap business per year to automatically lower to $3 billion in only a few short years without any affirmative vote of the Commission. This automatic lowering may occur regardless of the conclusions of a formal study of the matter required by the Commission – even if the study concludes that lowering the threshold is a bad thing to do!

Unquestionably, an arbitrary 60-percent decline in the swap-dealer registration threshold from $8 billion to $3 billion creates significant uncertainty for non-financial companies that engage in relatively small levels of swap dealing to manage business risk for themselves and their

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customers. It will have the effect of causing many non-financial companies to curtail or terminate risk-hedging activities with their customers, limiting risk-management options for end-users and ultimately consolidating marketplace risk in only a few large swap dealers. Such risk consolidation runs counter to the goal of Dodd-Frank to reduce systemic risk in the marketplace. The CFTC must not arbitrarily change the swap dealer registration de minimis level without a formal rulemaking process.

**D. Dodd-Frank Act Indemnification Requirements**

Under Sections 725, 728 and 763 of the Dodd-Frank Act, when a foreign regulator requests information from a US registered swap data repository (SDR) or derivatives clearing organization (DCO), the SDR or DCO is required to receive a written agreement from the foreign regulator stating that it will abide by certain confidentiality requirements and will “indemnify” the CFTC for any expenses arising from litigation relating to the request for information. In short, the concept of “indemnification” – requiring a party to contractually agree to pay for another party’s possible litigation expenses – is only well established in US tort law, and does not exist in practice or in legal concept in many foreign jurisdictions, thereby introducing complications to data-sharing arrangements with foreign governments and raising the possibility of data fragmentation at the international level.

Correcting this unworkable framework in the Dodd-Frank Act is not controversial, and Congress should absolutely provide a legislative fix to this issue, just as the Securities and Exchange Commission (SEC) has endorsed in testimony before Congressional Committees in the 112th Congress. Similarly, in the 113th Congress, H.R. 742 was introduced to provide a narrow fix on this issue and passed the House on June 12, 2013, by a vote of 420-2. The same provision should be included in any CFTC reauthorization legislation introduced by this Congress.

**E. Contracts with Volumetric Optionality**

Another topic of concern is risk-management contracts that allow for an adjustment of the quantity of a delivered commodity. These types of contracts, known as “Forward Contracts with Embedded Volumetric Optionality,” or EVO Forwards, are important to America’s economy. They provide farmers, manufacturers and energy companies with an efficient means of acquiring the commodities they need to conduct their daily business – at the right time and in the right amounts. This includes providing affordable sources of energy to millions of American households. EVO Forwards do not pose a threat to the stability of financial markets. They should not be regulated in the same manner as financial derivatives.

Forwards are expressly excluded from the definition of a “swap” under the Commodity Exchange Act. The CFTC’s original guidance on how to determine when an EVO Forward should also be considered a forward, and thus excluded, using a “Seven-Factor Test” has been burdensome, unnecessary and duplicative. The CFTC captured a large swath of transactions that were not and should not be regulated as “swaps,” including EVO Forwards.

Fortunately, the Commission last fall proposed through regular order an amended interpretation of the Seven-Factor Test.8 That proposal is a good start for providing some sensible relief from the problems arising from the test. I believe the best approach would be a new and more practical product definition. Short of that, I am listening carefully to recommendations by consumers and industry for a better interpretation.

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8 Forward Contracts With Embedded Volumetric Optionality, 79 FR 69,073 (proposed Nov. 20, 2014).
If not corrected, the regulation of these transactions will have the effect of increasing companies’ costs of doing business. It will force some businesses to curtail market activity and thereby consolidate risk in the marketplace rather than transfer and disperse it. That will ultimately raise costs for consumers. Such expensive and unnecessary regulation thwarts the intent of Congress under the Dodd-Frank Act.

F. Special Entity Utilities

The Dodd-Frank Act requires that American towns and municipalities be labeled as “special entities” when they enter into swaps transactions. The purpose was to provide specific protections for municipalities who used complex financial swaps of the type that ensnared Jefferson County, Alabama, and led it to file what – at the time – was the largest municipal bankruptcy in US history. Congress never intended, however, and Dodd-Frank does not include requirements to limit the ability of our not-for-profit utilities to manage ordinary risks associated with generating electricity or producing natural gas.

Unfortunately, the CFTC’s first shot at the “special entity” rule contained onerous restrictions on ordinary risk management activities by America’s not-for-profit taxpayer-owned utilities. It generated an enormous amount of public comment. Many commenters asserted that the rule would cause trading counterparties to avoid dealing with special entity utilities due to the increased regulatory compliance and registration burdens of being labeled as a swap dealer. That meant that these utilities would have had far fewer tools to control fluctuations in operational costs or supply and demand, resulting in increased electricity and other energy costs for American consumers.

The CFTC’s original special entity proposal also led to two identical pieces of legislation to correct the CFTC’s action in Congress, one passed the House unanimously, and the other was introduced in the Senate with 14 co-sponsors evenly split between both political parties.

Fortunately, in September of last year, the Commission finalized a rule change that recognized Congressional concern. It provided the relief that our not-for-profit taxpayer-owned utilities need to manage risks in the production of natural gas and electricity. Without the rule change, a regulatory action inspired by the Dodd-Frank Act would have increased utility rates for millions of Americans. In times of economic uncertainty, that would have been an unacceptable result. The legislative solutions offered during the last Congress, however, would still provide added certainty to the marketplace, and I support making the CFTC’s regulatory changes permanent in statute.

G. Margin Requirements for Uncleared Swaps

The CFTC’s proposed rules on margin for uncleared swaps are inconsistent with the European and IOSCO approach of exempting swaps transactions between certain affiliates from having to post initial margin. As a result, the cost of such initial margin in internal risk transfer trades will likely be borne by end-users. This added cost will discourage end-users from entering into swaps transactions with international swaps dealers that, in turn, look to offset the hedge in markets outside of the US.

An example is a US auto manufacturer looking to hedge US Dollar/Japanese Yen interest-rate risk through the use of an interest-rate swap provided by a Japanese-headquartered

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dealer. The added cost of initial margin on that dealer’s internal risk transfer trades will likely make that transaction cost-prohibitive for the US end-user, which will instead turn to a domestic dealer without access to the global market offering a necessarily wider bid-offer price spread.

The CFTC’s unwillingness to exempt dealer affiliates from having to post margin on uncleared swaps will have two adverse impacts on US end-users: First, it will subject US end-users to higher costs and wider bid-offer price spreads. Second, it will have the effect of ring-fencing financial risk in the US by increasing the costs of risk-hedging in broader global markets.

So, to those who asserted that the CFTC rules were designed to be a barrier to importing risk into the US, the effect of the CFTC’s unwillingness to exempt internal risk management swaps from initial margin is to encapsulate risk in the US marketplace increasing, rather than decreasing systemic hazard in American financial markets.

H. JOBS Act Harmonization

In letters to the CFTC, stakeholders representing a wide variety of market participants, such as SIFMA, the Managed Funds Association, and the Financial Services Roundtable requested that the Commission harmonize its “private offering” requirements in CFTC Rules 4.7 and 4.13(a)(3) with the broadened scope of solicitation permitted by the SEC after it proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933. The SEC’s proposed changes to the solicitation rules for securities offerings came about after the Jumpstart Our Business Startups Act (JOBS Act) was signed into law in April 2012,10 which allows for solicitation of accredited investors for private securities offerings in order to raise needed capital for companies to expand and create jobs. While the JOBS Act mandates consistent treatment of Regulation D, Rule 506 offerings across the federal securities laws, it unintentionally omitted harmonizing changes to the CFTC’s regulations, which created an inconsistency between the SEC’s rules and the CFTC’s rules governing solicitation.

Because relief was needed quickly so as to not impede use of the JOBS Act by the marketplace, I welcomed CFTC staff letter 14-116 issued on September 9, 2014, to provide relief to market participants from certain provisions of CFTC Regulations 4.7(b) and 4.13(a)(3) restricting marketing to the public.11 However, because permanent changes to our regulations via statutory language provides the most certainty to the marketplace, I support the inclusion of the language from H.R. 4413 and H.R. 4392 from the last Congress which would provide an exemption for any registered commodity pool operator parallel to the exemption provided for general solicitation of securities under the JOBS Act.

I. Residual Interest Calculation

In March, I welcomed a change to CFTC Rule 1.22 that impacted when residual interest for FCMs would be calculated.12 Without the recent rule change, the so-called and, perhaps, misnamed “customer protection” rule finalized in October 2013 would likely have resulted in significant harm to the core constituents of this Commission: the American agriculture producers who use futures to manage the everyday risk associated with farming and ranching.

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Without the rule change, farmers and ranchers would likely have been forced to prefund their futures margin accounts due to onerous requirements forcing FCMs to hold large amounts of cash in order to pay clearinghouses at the start of trading on the next business day. The increased costs of pre-funding accounts would likely have driven many small and medium-sized agricultural producers out of the marketplace. It would likely have forced a further reduction in the already strained FCM community that serves the agricultural community.

When I visited a grain elevator in southern Indiana and a family farm in rural Kentucky last November, I had lunch with around a dozen small family farmers, some of whom use futures products to manage price and production risk. Simply put, they could not fathom why the CFTC would adopt a rule requiring them to pre-fund margin accounts. They saw the former version of our rule as insuring that they would actually lose MORE of their money – not less – in the event of a future failure of another MF Global or Peregrine Financial.

After a significant amount of public comment, and two identical and bipartisan pieces of legislation in both the House and the Senate last Congress, the Commission fortunately amended CFTC Rule 1.22 so that the residual interest deadline does not automatically adjust to the start of business the next morning after a trade, and instead would remain at the close of business the next day following a trade. While the change to this deadline can now only take place after a rulemaking following a public comment period, the legislative solutions offered in H.R. 4413 and S. 2601 during the 113th Congress would go one step further and provide added certainty to the marketplace by not allowing residual interest to be calculated any earlier than the close of business on the next business day following a trade. This approach is especially important given the potential impact on smaller FCMs and the farmers and ranchers who depend on their risk management services.

J. Futures Customer Protections

In H.R. 4413 from the last Congress, there were several provisions that would have made several CFTC and National Futures Association (NFA) regulatory changes permanent in statute to help protect futures customers following the failure of Peregrine Financial and MF Global. Similar to the Commission’s recent change improving when residual interest is calculated, I support the important changes H.R. 4413 sought to make requiring that FCMs strengthen their controls over the treatment and monitoring of funds held for customers trading in the US and foreign futures and options markets. In addition, codifying the electronic confirmation of customer funds, which was first proposed by futures industry self-regulatory organizations, and codifying when an FCM must notify regulatory authorities when it faces an undercapitalization scenario would help to protect futures customers from another failure similar to MF Global. Finally, I also support clarifying the definition of customer property to bolster CFTC Regulation 190.08 to ensure farmers and ranchers are not left waiting for months or years to recover their funds held in legally segregated accounts in the event of an FCM insolvency.

II. Derivatives Trading Position Limits

When I joined the Commission ten months ago, the Energy and Environmental Markets Advisory Committee (EEMAC) had not met since 2009. EEMAC is the only CFTC advisory committee that was formalized in the Dodd-Frank Act. Clearly, Congress believed that it was important to make EEMAC a permanent forum to examine CFTC actions affecting US energy markets. Since the passage of Dodd-Frank, we have had a sea change in the CFTC’s influence on US energy markets. At the same time, the markets themselves are undergoing the largest technological and structural changes in a generation. That fact makes EEMAC a critical facility
for examining how CFTC regulations impact energy companies, utilities and everyday American consumers.

The CFTC’s position-limits proposals are so complex and concerns about them so widespread by stakeholders in US energy markets that they occupied the entire discussion at the first EEMAC meeting on February 26, 2015. The meeting focused on three topics: (1) the data supporting position limits; (2) the likely impact of this rulemaking on liquidity; and (3) the proposed redefinition of bona fide hedging.

A. Data Raises Serious Questions

Compelling evidence presented at the EEMAC meeting supports the contention that additional federal position limits are not necessary in energy markets. The EEMAC heard evidence that the run-up in oil prices before the financial crisis did not bear any of the signs of excessive speculation.\(^\text{13}\) This discussion aligns with the same findings made by the CFTC’s chief economist in 2008.\(^\text{14}\) Similarly, the EEMAC heard powerful evidence that speculators are not responsible for the significant declines in oil prices over the last nine months.\(^\text{15}\)

In fact, Energy Information Administration Administrator Adam Sieminski aptly pointed out that “something had to happen” when the supply of oil in the markets became out of balance with global demand and that “something” was price decline. Both he and University of Houston Professor Craig Pirrong indicated that non-fundamental market factors, such as speculation, played only a negligible, if any, role in the recent sharp decline in domestic and global energy prices. Similarly, another well-informed presenter’s analysis asserted that index investors, managed money and swap dealers all had “no discernible impact [or] influence” on oil prices from approximately January 2011 through January 2015.\(^\text{16}\)

In addition, the EEMAC heard persuasive testimony that sudden and unreasonable changes in commodity prices flowing from excessive speculation are the ones the CFTC can most readily identify and prosecute using existing tools, such as the ban on manipulation and disruptive trading practices.\(^\text{17}\)

1. “Excessive Speculation”

The CFTC has attempted to cast its proposed rules as necessary to curb excessive speculation. Yet, the evidence adduced at the EEMAC meeting suggests otherwise. The CFTC primarily relies on two “black swan” episodes of market manipulation (the Hunt Brothers and Amaranth) in two commodities (silver and natural gas) to find that position limits are necessary in 28 commodities. It is critical to note, however, that market manipulation is generally distinct from excessive speculation. Respected economists highlighted the simple fact that these concepts

\(^{13}\) EEMAC Transcript (Feb. 26, 2015) (EEMAC Tr.) at 29-34.
\(^{14}\) Dr. Jeffrey Harris, the CFTC’s then-Chief Economist, testified before Congress that there was “little evidence that changes in speculative positions are systematically driving up crude oil prices.” Tom Doggett, \textit{Congress Told Speculators Not Driving Up Oil Price}, Reuters, Apr. 3, 2008, available at http://uk.reuters.com/article/2008/04/03/us-cftc-oil-speculators-idUKN0337748220080403.
\(^{15}\) EEMAC Tr. at 36-38.
\(^{16}\) See Thomas LaSala, EEMAC Panel I (Feb. 26, 2015) at 4-7, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/generic/eemac022615_lasala1.pdf; see also EEMAC Tr. at 73-78.
\(^{17}\) EEMAC Tr. at 40.
are “very different.” The CFTC has ample tools not only to detect manipulation, but also to punish it.

EEMAC members offered concrete suggestions to address many of the aspects of the proposed rules that simply will not work for the energy markets. These discussions centered on two main concerns: (1) that proposed CFTC position limits may reduce liquidity for hedging purposes; and (2) that the CFTC’s approach to bona fide hedging is flawed and could put hedgers at risk.

B. Disappearing Liquidity

Exchanges that list energy derivatives explained that, although markets are working well, liquidity is starting to become shallower, particularly along points farther out the curve. Where liquidity is available, wide bid-ask spreads make it increasingly costly and harder to hedge. EEMAC members reported that liquidity is often scarcest in some of the smaller markets, such as regional power and gas markets, where liquidity has started to dry up completely. This reduction of liquidity has resulted from the withdrawal of speculators from the markets.

To prevent further erosion of liquidity at the most critical points, the EEMAC discussed two potential changes to address the negative impact the CFTC’s proposal would have on liquidity: accountability and updated deliverable supply.

1. Accountability

The first of these changes would call on the CFTC to utilize a system of position accountability. Position accountability is a process long utilized by futures exchanges – and approved not only by the CFTC but also by Congress – to obtain more detailed information from futures market participants that have reached specified position thresholds. Based on that and other information, the exchange may order the market participant to cap, reduce or even liquidate a position. This tool is essential because, as it was explained at the meeting, “as you get further out the curve, there’s naturally less liquidity, less players,” while adequate liquidity at those points in the market remains quite important to hedgers.

To guard against concentration risk, futures exchanges monitor market participants – and the market as a whole – carefully when they reach certain levels. Under this careful supervision, market participants may be allowed to exceed the position-limit levels the Commission has proposed. As an added safeguard for use of position accountability, the CFTC also periodically evaluates the adequacy of exchange implementation of position accountability. The

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18 Id. at 16. See also id. at 30.
20 E.g. id. at 81-82, 91-92, 95-96, 103-04, 174-76.
21 Id. at 220-22.
22 Id. at 81-83.
23 See 7 U.S.C. 7(d)(5).
24 E.g. id. at 106.
25 Id. at 107.
26 Id. at 107-08.
exchanges and the CFTC collaborate to ensure that positions across markets are monitored and policed under a position-accountability regime.28

The CFTC’s position limits proposal gives short shrift to the exchanges’ long experience and expertise using position accountability methods to assess the propriety of market participants’ positions in light of conditions in the market as a whole, including the depth and shallowness of available liquidity. Indeed, it appears that dismantling this system and replacing it with the CFTC’s proposed hard limit levels would undoubtedly harm liquidity in the spot month and beyond, without commensurate enhancement of market integrity.29

2. Updated Deliverable Supply

Second, the EEMAC discussed the necessity for the CFTC to review and update its deliverable-supply estimates. The CFTC’s proposed deliverable-supply estimates appear deficient in several respects. They must be improved to have any hope of creating a viable position-limits regime. EEMAC heard compelling evidence that deliverable-supply calculations, like so many other aspects of position limits, cannot be done on a “one-size-fits-all” basis. Energy markets have unique characteristics that must be specially considered in calculating deliverable supply.30

The CFTC’s proposed method of calculating deliverable supply is particularly deficient as to natural gas and electricity because it ignores – and does not permit the exchanges to consider – “supply that is in a different location but can still serve demand in a certain area through transportation of that commodity.”31 This deficiency underscores the need for the CFTC to exercise great care when imposing concepts that may work for agricultural markets, for example, but do not work for energy markets, which function quite differently.32

In addition, the deliverable supply estimates the Commission proposes to use are terribly out of date. The Commission proposes to use 1983-vintage deliverable-supply estimates in setting silver and gold spot-month position limits, and 1996-era deliverable-supply estimates for natural gas.33 We have had a revolution in natural gas exploration and production since the mid-nineties, so it is critical that the CFTC adopt contemporary deliverable-supply estimates.

C. Bona Fide Hedging: Risk Management at Risk

Importantly, the EEMAC meeting also focused closely on the CFTC’s sweeping proposals to circumscribe the bona fide hedging exemption to position limits. Congress intended that position limits target those who engage in “excessive speculation,” while leaving hedgers to their task of reducing risk in their businesses. Unfortunately, the EEMAC heard evidence that the CFTC’s proposal unduly focuses on “limiting the activity of commercials in hedging in the markets,” which in turn increases the risk of pricing commodities, the cost of which “is ultimately borne by consumers.”34

Let me briefly summarize a few elements of the CFTC’s significant reduction of the bona fide hedging exemption:

28 EEMAC Tr. at 139-40.
29 See EEMAC Tr. at 108-12; Proposal, 78 FR at 75,839-40 (proposed App. D); Proposal, 78 FR at 75,766.
30 Id. at 99-100, 112.
31 Id. at 100, 131-33.
32 See, e.g., id. at 130-33.
33 CME Comment Letter at 3 (Feb. 20, 2014).
34 EEMAC Tr. at 157-58, 183.
1. **Storage Transactions**

In a reversal from its 2011 proposal, the CFTC no longer recognizes as bona fide transactions used to hedge risk from storage, transmission or generation of commodities. The EEMAC learned that these transactions form the “bread and butter” of energy industry efforts to hedge risks – and thereby pass along the best possible prices to consumers.\(^{35}\) Although the CFTC once recognized the legitimacy of this sort of hedge, the new proposal apparently denies bona fide hedge treatment because of the fear of abuse in the agricultural sector, where a storage bin could be used for multiple commodities\(^{36}\) – soybeans and corn, for example. Yet, the proposed rule does not explain why this transaction is unavailable in the energy space, where storage, transmission and generation are obviously not fungible in the same way.\(^{37}\) I recently toured the Valero refinery in Houston, and it was a fascinating and educational experience. But I did not need to have a chemical engineering degree to understand that liquefied natural gas or generated electricity cannot be stored in a gasoline tank farm. The CFTC rules need to recognize that as well.

2. **Merchandising and Anticipatory Hedging**

EEMAC members expressed considerable frustration that the CFTC's proposal does not recognize the importance of merchandising and its role in connecting the two ends of the value chain: production and consumption.\(^{38}\) Moreover, merchandising promotes market convergence, an important component of price discovery and market health.\(^{39}\) EEMAC members explained that unfixed price contracts are frequently used in merchandising transactions and argued forcefully that the CFTC should re-evaluate its approach to basis contracts.

3. **Cross-Commodity Hedges**

EEMAC members also raised significant concerns with the CFTC's application of the hedge exemption to cross-commodity hedges. Cross-commodity hedging, such as hedging jet fuel with ultra-low sulfur diesel futures contracts, is currently permitted in the spot month and is critical to the price-discovery process, but would not be permitted under the position-limits proposal.\(^{40}\) Similarly, EEMAC members stated that the proposed quantitative restriction on cross-commodity hedges was deeply problematic.\(^{41}\) This proposed quantitative restriction would kill long-used, tried-and-true cross-commodity hedges, including hedging electricity with natural gas and fuel oil with crude oil.\(^{42}\)

4. **Gross versus Net Hedging**

Finally, EEMAC members raised concerns regarding the CFTC's proposed approach of permitting hedging only on an enterprise-wide level. The EEMAC heard evidence that this approach substitutes regulatory edict for the common-sense business judgments that underlie existing risk-management procedures and hedging programs.\(^{43}\) The risk-management systems

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\(^{35}\) Id. at 170-76.
\(^{36}\) Id. 174-75.
\(^{37}\) E.g. id. at 178-79.
\(^{38}\) E.g. id. at 161-62, 190-91, 209.
\(^{39}\) E.g. id. at 191.
\(^{40}\) Id. at 115-16.
\(^{41}\) E.g. id. at 191, 200-03; see also Proposal, 78 FR at 75,717-18 (describing quantitative factor and suggesting it should not apply to electricity-natural gas cross commodity hedging).
\(^{42}\) EEMAC Tr. at 200-03.
\(^{43}\) E.g. id. at 158-60, 186-87, 216-18.
and procedures on which so many hedgers depend were built in reliance on long-standing CFTC interpretations, which this proposal changes suddenly and with questionable justification.\textsuperscript{44} In some cases, the CFTC’s proposed approach is in tension with other state or federal regulatory requirements with regard to hedging or reliability.\textsuperscript{45}

In short, the Commission and the staff have to think carefully about many aspects of the proposed bona fide hedge exemption. I am very concerned that the effect of the CFTC’s proposed narrow list of exemptions is to impose a federal regulatory edict in place of business judgment in the course of risk-hedging activity by America’s commercial enterprises. The CFTC instead must allow for greater flexibility. It must encourage commercial enterprises to adapt to developments and advances in hedging practices, not impede their efforts to do so. The CFTC needs to take special care that in chasing excessive speculation, it does not needlessly add unnecessary burdens on hedgers, end-users and consumers – the very participants that Congress intended to protect against excessive speculation.

The position-limits rulemaking is a significant undertaking and both the Commission and its staff are struggling to get it right. I continue to keep an open mind on how the difficult questions raised before the EEMAC should be resolved. I am guided in this endeavor by two major principles. First, we need to follow the data. Considering the data and research in the record, significant questions remain as to whether additional federal position limits are necessary. Even if one accepts that additional federal limits are necessary, these limits must be appropriate. The only way to make this determination is to draw upon current and accurate data and confirm that the rule proposal will facilitate price discovery, maintain liquidity and not unduly disrupt markets that by all accounts are functioning fairly well. We should all agree that basing such important rule making on twenty or thirty year old data is simply unacceptable in a modern, well-regulated economy.

Second, the Commission must be attentive to the costs and benefits of its rulemaking. There is no doubt that this rule will be very expensive and that hedgers will bear a significant share of the costs. Moreover, as an EEMAC member observed, this rule is likely to result in higher costs for consumers of energy and will be felt most heavily by low-income Americans.\textsuperscript{46} Before making a shaky necessity finding, construing an ambiguous statute or even putting in place individual aspects of its proposal, the CFTC needs to undertake a clear-eyed assessment of the costs and benefits associated with expanding the position-limits rule.

III. CFTC Swaps Trading Rules

In January of this year, I issued an extensive White Paper analyzing the mismatch between the CFTC’s swaps trading regulatory framework and the distinct liquidity and trading dynamics of the global swaps markets.\textsuperscript{47}

The White Paper asserts that Congress got much of Dodd-Frank’s swaps trading rules right. Congress laid out a straightforward and flexible swaps trading regulatory framework well-suited to the episodic nature of swaps liquidity and swaps market dynamics.

\textsuperscript{44} See id.
\textsuperscript{45} Id. at 216-18.
\textsuperscript{46} Id. at 196-99.
Unfortunately, the CFTC’s implementation of the swaps trading rules widely misses the congressional mark. I believe the rules are fundamentally flawed for a number of reasons:

- Because they inappropriately adopt a US-centric futures regulatory model that supplants human discretion with overly complex and highly prescriptive rules;
- Because they are largely incompatible with the distinct liquidity, trading and market structure characteristics of the global swaps markets;
- Because they fragment swaps trading into numerous artificial market segments and drive global market participants away from transacting with entities subject to CFTC swaps regulation;
- Because they exacerbate the already inherent challenge in swaps trading – maintaining adequate liquidity – and thus increase market fragility and the systemic risk that the Dodd-Frank reforms were predicated on reducing; and
- Last, but foremost, because they do not do what Dodd-Frank expressly required them to do. They simply do not comply with the clear provisions of the law.

A. The CFTC’s Flawed Swaps Trading Regulatory Framework

Let me highlight a few of the key flaws in the swaps rules, starting with:

1. Limits on Methods of Trade Execution

CFTC rules for SEFs create two categories of swaps transactions: Required Transactions and Permitted Transactions. Required Transactions must be executed in an order book (Order Book) or an RFQ system in which a request for a quote is sent to three participants operating in conjunction with an Order Book (RFQ System). Permitted Transactions allow for any method of execution, but SEFs must also offer an Order Book for such transactions.

There is simply no statutory support for the CFTC’s “required” and “permitted” distinction. There is no support for segmenting swaps into two categories or for limiting one of those categories to two methods of execution. Rather, Congress’s SEF definition encompasses a platform where multiple participants have the ability to execute swaps with multiple participants through any means of interstate commerce, including a trading facility. This broad and flexible definition allows execution methods beyond an Order Book or RFQ System for all swaps, not just some swaps. The statutory language contains a multiple-to-multiple participant trading requirement, not an all-to-all trading requirement. The CFTC Order Book obligation is, simply, made up out of thin air.

48 17 C.F.R. 37.9(a)(1).
49 17 C.F.R. 37.9(c)(1).
50 17 C.F.R. 37.3(a)(2), 37.3(a)(3) and 37.9(a)(2).
51 17 C.F.R. 37.9(a)(2) and 37.9(a)(3).
52 17 C.F.R. 37.9(c)(2).
53 17 C.F.R. 37.9(a)(2); Core Principles and Other Requirements for Swap Execution Facilities, 78 FR 33,476, 33,504 (Jun. 4, 2013) (SEF Rule).
54 CEA section 1a(50); 7 U.S.C. 1a(50).
Congress further permitted SEFs to offer swaps trading “through any means of interstate commerce.” The CFTC rules acknowledge this phrase but construe it narrowly to allow for voice and other “means” of execution only within the limited Order Book and RFQ System execution methods. Yet, the phrase “interstate commerce” has a rich and well-developed constitutional history, which US federal courts have interpreted to cover almost an unlimited range of commercial and technological enterprise. The CFTC’s narrow construct is disingenuous and not supported by the courts’ long-established interpretation of the Commerce Clause.

Congress could have required SEFs to offer certain limited execution methods but chose not to do so. Congress could have limited swap execution to the trading facility execution method that futures exchanges are required to use. Congress did not do so. Congress could have preserved references to “electronic execution” included in early drafts of the Dodd-Frank Act, but it did not do so in the final statutory text.

Electronic order books may be the standard method of trade execution in the futures markets, but that is not the case with swaps. The SEF definition reflects an understanding that, given swaps’ generally episodic liquidity, a broad variety of execution methods are necessary. The Dodd-Frank Act did not seek to alter swaps’ natural trading and execution dynamics, so we at the CFTC do not have the authority to do otherwise.

2. Block Transactions

The CFTC block trade definition, specifically, the “occurs away” requirement, is another example of artificial market segmentation. The CFTC defines a block trade as “a publicly reportable swap transaction that: (1) involves a swap that is listed on a registered SEF or DCM; (2) ‘occurs away’ from the registered SEF’s or DCM’s trading system or platform; and (3) has a notional or principal amount at or above the appropriate minimum block size applicable to such swap….”

The block trade definition is a holdover from the futures model. In the futures market, block trades occur away from the DCM’s trading facility as an exception to the centralized market requirement given the price and liquidity risk of executing these large-sized trades.

55 17 C.F.R. 37.9(a)(2)(ii); SEF Rule at 33,501-02. The Commission states that “in providing either one of the execution methods for Required Transactions in § 37.9(a)(2)(i)(A) or (B) of this final rulemaking (i.e., Order Book or RFQ System that operates in conjunction with an Order Book), a SEF may for purposes of execution and communication use ‘any means of interstate commerce,’ including, but not limited to, the mail, internet, email, and telephone, provided that the chosen execution method satisfies the requirements provided in § 37.3(a)(3) for Order Books or in § 37.9(a)(3) for Request for Quote Systems.” SEF Rule at 33,501.
56 See, e.g., Gonzales v. Raich, 545 U.S. 1, 17 (2005); Katzenbach v. McClung, 379 U.S. 294, 302 (1964); Wickard v. Filburn, 317 U.S. 111, 125 (1942).
57 Compare S. 3217, 111th Cong. § 720 (as reported by S. Comm. on Banking, Housing, and Urban Affairs, Apr. 15, 2010) (defining a SEF as “an electronic trading system” and discussing electronic execution of trades), with 7 U.S.C. 1a(50) (defining a SEF as “a trading system or platform” without reference to electronic execution).
58 17 C.F.R. 43.2.
59 Compare S. 3217, 111th Cong. § 720 (as reported by S. Comm. on Banking, Housing, and Urban Affairs, Apr. 15, 2010) (defining a SEF as “an electronic trading system” and discussing electronic execution of trades), with 7 U.S.C. 1a(50) (defining a SEF as “a trading system or platform” without reference to electronic execution).
60 See Alternative Executive, or Block Trading, Procedures for the Futures Industry, 64 FR 31,195 (Jun. 10, 1999); Chicago Board of Trade's Proposal To Adopt Block Trading Procedures, 65 FR 58,051 (Sep. 27, 2000).
61 17 C.F.R. 38.500; Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9, 73 FR 54097, 54099 (proposed Sep. 18, 2008).
In today’s global swaps market, however, there are no “on-platform” and “away-from-platform” execution distinctions. Over-the-counter (OTC) swaps trade in very large sizes. These swaps are not constrained to trading facilities, but trade through one of a variety of execution methods appropriate for the product’s trading liquidity.

Again, the Dodd-Frank Act recognized these differences by not imposing on SEFs an open and competitive centralized market requirement. Rather, Congress expressly authorized delayed reporting for swap block transactions.\textsuperscript{63} Congress got it right.

We at the CFTC have got the swaps block trade definition wrong. There is no statutory support for the “occurs away” requirement. The requirement creates an arbitrary and confusing segmentation between non-block trades “on-SEF” and block trades “off-SEF.” The “off-SEF” requirement undermines the legislative goal of encouraging swaps trading on SEFs.\textsuperscript{64} In short, it needs to be changed.

3. Made Available to Trade

Congress included a trade execution requirement in the Commodity Exchange Act that requires SEF execution for swaps subject to the clearing mandate.\textsuperscript{65} In an innocuous exception to this requirement, Congress stated that the trade execution requirement does not apply if no SEF “makes the swap available to trade.”\textsuperscript{66}

Based on nothing other than these six words, the CFTC has created an entire new regulatory mandate that is now known as the “made available to trade” or MAT process.\textsuperscript{67} Yet, a plain reading of Dodd-Frank’s trade execution requirement shows that Congress never intended to create such a regulatory framework around these six words. Unlike the clearing mandate, the trade execution requirement provided no regulatory process for moving some swaps on-SEF and keeping others off.\textsuperscript{68}

Congress could have specified a regulatory process for the trade execution requirement as it did for the clearing mandate, but it chose not to. Unlike futures, which begin life on an exchange where they may or may not attract liquidity, newly developed swaps products are initially traded bilaterally and only move to a platform once trading liquidity is assured. Congress’s trade execution requirement merely reflects the simple logic that a clearing-mandated swap must be executed on a SEF provided that the particular swap is sufficiently liquid that some SEF makes it available to trade (i.e., offers the swap for trading). This logical condition was not meant to serve as the basis for a new CFTC regulatory process.

This MAT process would not even be necessary if the CFTC allowed SEFs to offer swaps trading through “any means of interstate commerce,” exactly as Congress authorized. In short, the MAT process is not supported by the text of Dodd-Frank or the inherent nature of global swaps trading.

\textsuperscript{63} CEA section 2(a)(13)(E); 7 U.S.C. 2(a)(13)(E).
\textsuperscript{64} CEA section 5h(e); 7 U.S.C. 7b-3(e).
\textsuperscript{65} CEA section 2(h)(8); 7 U.S.C. 2(h)(8).
\textsuperscript{66} Id.
\textsuperscript{67} Id.
\textsuperscript{68} Compare CEA section 2(h)(1), 2(h)(2) and 2(h)(3); 7 U.S.C. 2(h)(1), 2(h)(2) and 2(h)(3), with CEA section 2(h)(8); 7 U.S.C. 2(h)(8).
Congress should not support the CFTC in any assertion of greater control over the MAT process. Rather, the CFTC should withdraw its MAT regulations and, instead, conform its rules to the express Congressional text of Title VII, permitting SEFs to conduct their operations using such “means of interstate commerce” as they deem most suitable to serve their customer needs in the particular swaps products and marketplaces in which they operate.

4. Impartial Access

Dodd-Frank requires SEFs to have rules to provide market participants with impartial access to the market and to establish rules regarding any limitation on access. For some reason, CFTC staff appear to view these provisions as requiring SEFs to serve every type of market participant in an all-to-all market structure. Given the Dodd-Frank Act’s reference to limitations on access and its flexible SEF definition, however, efforts to require SEFs to serve every type of market participant in all-to-all marketplaces are unsupportable.

Impartial access must not be confused with open access. Impartial access, as the CFTC noted in the preamble to the final SEF rules, means “fair, unbiased, and unprejudiced” access. This means that a SEF should apply this standard to its participants; it does not mean that a SEF is forced to serve every type of participant in an all-to-all futures-style marketplace. Only Congress could have imposed an all-to-all trading mandate; it chose not to do so.

5. Void Ab Initio

CFTC staff has issued guidance stating that any swap trade that is executed on a SEF and that is not accepted for clearing is invalid from the beginning or “void ab initio.”

The CFTC’s void ab initio policy has no support in the Dodd-Frank Act. There are legitimate reasons, such as operational or clerical errors, that cause trades to be rejected from clearing. The void ab initio policy creates a competitive disadvantage for the US swaps market relative to the US futures market, which does not have such a policy. Further, the void ab initio policy may well introduce additional risk into the system when a participant enters into a series of swaps to hedge its risk but one or more swaps is declared void ab initio. In this case, the participant will not be correctly hedged, which creates additional market and execution risk.

6. Core Principles

Congress provided a core principles-based framework for SEFs. Unfortunately, the Dodd-Frank Act missed the mark with respect to the SEF core principles, most of which are based on the DCM core principles. The futures regulatory model is an inappropriate template for SEF core principles. This problem has been magnified by unwarranted amendments to CFTC rules making SEFs self-regulatory organizations (SROs) and requiring them to comply with very prescriptive rules modeled after futures exchange practices that are unsuitable for the way swaps trade. Although the SEF core principles contain certain regulatory obligations, Dodd-Frank did not instruct the CFTC to make SEFs SROs or take a prescriptive rules-based approach.
approach. In fact, the statute provides SEFs with reasonable discretion to comply with the core principles. The CFTC should draw on its long and successful experience as a principles-based regulator to implement a flexible core principles-based approach for SEFs that aligns with inherent swaps market dynamics.

I recommend the following changes to the SEF core principles set out in Title VII of the Dodd-Frank Act.

**Monitoring of trading and trade processing.** SEF Core Principle 4 requires SEFs to monitor trading in swaps to prevent manipulation, price distortion and disruptions of the delivery or cash settlement process, among other things. Certain rules promulgated under Core Principle 4 require a SEF to look beyond its own market to gain the information necessary to perform these functions. For example, CFTC Regulation 37.404(a) requires a SEF to “demonstrate that it has access to sufficient information to assess whether trading in swaps listed on its market, in the index or instrument used as a reference price, or in the underlying commodity for its listed swaps is being used to affect prices on its market.” In other words, a SEF that executes a credit default swap on a Ford Motor Company bond must also monitor trading in the underlying Ford Motor Company bonds to prevent manipulation, price distortion and disruption in its market. While a SEF has the ability to monitor trades it executes, asking it to monitor manipulation in another marketplace in which it may provide no execution services is an undue, unfair and unwarranted burden.

The CFTC acknowledges this challenge. Its website regarding market surveillance states that only the CFTC itself can “consolidate data from multiple exchanges and foreign regulators to create a seamless, fully-surveilled marketplace” due to its unique space in the regulatory arena. The surveillance “requires access to multiple streams of proprietary information from competing exchanges, and as such, can only be performed by the Commission or other national regulators.” The CFTC correctly states that the surveillance “cannot be filled by foreign and domestic exchanges offering related competing products,” and there is no reason to believe that a SEF is better situated. And yet, despite this broad disclaimer, each SEF that fails to fulfill this sort of surveillance function will be in violation of SEF Core Principle 4 and CFTC rules.

Congress should clarify SEF Core Principle 4 to make clear that a SEF is not required to monitor markets beyond its own. The CFTC should also revise its rules to this effect. As the CFTC admits on its website, only it can perform cross-market surveillance.

**Position limits.** SEF Core Principle 6 places the burden for position limits and position accountability levels on SEFs that are trading facilities. The Dodd-Frank Act got this core principle wrong.

The setting of position limits or position accountability levels by SEFs is very problematic. As I explained in my White Paper, SEFs do not own swaps products, which trade on multiple

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75 CEA section 5h(f)(1)(B); 7 U.S.C. 7b-3(f)(1)(B).
76 CEA section 5h(f)(4); 7 U.S.C. 7b-3(f)(4).
77 17 C.F.R. 37.404(a).
79 Id.
80 Id.
81 CEA section 5h(f)(4); 7 U.S.C. 7b-3(f)(4).
82 CEA section 5h(f)(6); 7 U.S.C. 7b-3(f)(6).
competing SEFs and bilaterally off-SEFs. SEFs lack knowledge of a market participant’s activity on and off other venues. SEFs only have information about swaps transactions that occur on their platforms and thus do not know whether a particular transaction on their platform adds to, or offsets all or part of, a participant’s existing position. Therefore, SEFs are not able to calculate the total position of a market participant or monitor it against any position limit. As explained in the Core Principle 4 discussion above, only a markets regulator, such as the CFTC, that has a full picture of the market can perform cross-market monitoring and surveillance functions. Position-limit monitoring and surveillance is another such area.

Congress should revise Core Principle 6 to reflect that the CFTC, or possibly a designee, should set and monitor swaps position limits or accountability levels. Until Congress revises this futures-based core principle, the CFTC staff should continue to work with SEFs to derive a solution that ameliorates this burden on SEFs. Any regulatory demand that SEFs set or monitor limits or levels is an impossible exercise that adds extraordinary costs.

**Emergency authority.** SEF Core Principle 8 requires a SEF to “adopt rules to provide for the exercise of emergency authority … including the authority to liquidate or transfer open positions in any swap …” In its current form, this futures-based core principle places an impossible burden on SEFs. Congress should revise it to better suit the realities of the swaps market.

A SEF does not have the ability to liquidate or transfer open swaps positions because SEFs do not hold positions on behalf of their participants. As several commenters to the final SEF rules have explained, a SEF is not the appropriate entity to order the liquidation or transfer of these positions in an emergency because it does not have the ability or legal right to do so. The CFTC or a DCO, for cleared swaps, for example, are more appropriate entities to exercise this authority. Until Congress revises this futures-based core principle, the Commission and its staff should work to revise CFTC guidance under SEF Core Principle 8 to at most require a SEF to adopt rules for coordination with a DCO or the CFTC to facilitate the liquidation or transfer of open positions in an emergency.

**Financial resources.** SEF Core Principle 13 requires a SEF to have “financial resources [in an amount that] exceeds the total amount that would enable the [SEF] to cover the operating costs of the [SEF] for a 1-year period, as calculated on a rolling basis.”

The market impact of a SEF failure is not nearly comparable to the effect of a DCM failure, so it does not make sense for a SEF to hold one year of financial resources. A SEF failure will not likely create a liquidity crisis because most swaps trade on multiple SEFs, and there are multiple liquidity pools available in which to trade. Participants can easily trade on another SEF in the event of a failure. This is in contrast with the futures market, where the impact on market liquidity is of greater concern in the event of a DCM failure because a DCM owns its products and those products only trade on that specific DCM. Thus, there is one liquidity pool. The failure of one DCM will likely harm this liquidity unless regulators take action to transfer those products and the corresponding open interest to another DCM or participants move to another product on another DCM. Given these differences, SEFs should not be held to the same one-year financial-resources requirement as DCMs.

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83 CEA section 5(h)(f)(8); 7 U.S.C. 7b-3(f)(8).
84 SEF Rule at 33,536.
85 Id.
86 CEA section 5(h)(f)(13); 7 U.S.C. 7b-3(f)(13).
The financial-resources requirement is overly burdensome and disproportionately impacts SEFs that offer voice-based execution methods. These SEFs must significantly increase their financial resources to cover the compensation of employee brokers who facilitate execution through these voice-based methods. This requirement ties up additional capital for these SEFs, which puts them at a competitive disadvantage.

Congress should reexamine this core principle and only require a SEF to hold enough capital to conduct an orderly wind-down of its operations. It would not take a SEF one year to terminate employees and contracts and conduct an orderly wind-down of its operations. It would not be unreasonable to expect a SEF to conduct such a wind-down in three months. This approach would release significant capital back to the SEF for innovation, lower barriers to entry, reduce costs and increase competition.

In the meantime, the Commission and staff should reexamine CFTC rules and work with SEFs to reduce their financial burden. The Commission and staff could, for example (1) flexibly interpret a SEF’s financial resources to include additional resources such as projected revenues or projected capital contributions, (2) flexibly interpret operating costs to mean wind-down costs or to exclude certain costs not directly tied to core principle compliance or (3) flexibly interpret operating costs to exclude compensation that is not payable unless and until collected by the SEF.

B. Adverse Consequences of the CFTC’s Swaps Trading Regulatory Framework

I have reviewed some of the chief flaws in the CFTC swaps trading rules. Let me now address some of the adverse consequences for US financial markets.

Non-US person market participants’ efforts to avoid the ill-designed US swaps trading rules are fragmenting global swaps markets between US persons and non-US persons and driving away global capital. This phenomenon is fostering smaller, disconnected liquidity pools and less efficient and more volatile pricing. Market fragmentation is exacerbating the inherent challenge of swaps trading – maintaining adequate liquidity.

Divided markets are more brittle, posing a risk of failure in times of economic stress or crisis. Fragmentation increases firms’ operational risks as they structure themselves to avoid US rules and now must manage multiple liquidity pools in different jurisdictions. Fragmentation also increases trading firms’ operational and structural complexity and reduces their efficiency in the markets. In short, market fragmentation caused by the CFTC’s ill-designed trading rules – and the application of those rules abroad – is harming liquidity and increasing the systemic risk that the Dodd-Frank Act was predicated on reducing.

In addition to global market fragmentation, the CFTC’s unwarranted slicing and dicing of swaps trading into a series of novel regulatory categories, such as Required Transactions and

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87 It is a common practice in traditional voice brokerage firms for the bulk of compensation of client-facing personnel to be calculated as a percentage of transaction commissions generated and collected by the employer. Such aggregate compensation is often one of the largest components of operating costs at such firms.
Permitted Transactions and block transactions “off-SEF” and non-blocks “on-SEF,” each with their corresponding execution methods, has fragmented domestic swaps trading into an artificial series of smaller and smaller pools of trading liquidity, increasing market inefficiencies. So long as such disparate segments remain, US swaps markets face a CFTC-imposed liquidity challenge compared with non-US markets.

The CFTC’s swaps trading regime is also threatening the survival of many SEFs. The CFTC’s prescriptive and burdensome rules have ensured that operating a SEF is an expensive, legally intensive activity.90 This may drive consolidation in the industry, providing trading counterparties with less choice of where and how to execute swaps transactions.

Further, the swaps trading rules are hindering technological innovation. In 1899, US Patent Commissioner Charles H. Duell is said to have pronounced that “everything that can be invented has been invented.”91 Not to be outdone, the CFTC’s SEF rules pre-suppose that order book and RFQ methodologies are today and will always remain the only suitable technological means for US swaps execution. These restrictive SEF rules close US swaps markets to promising technological development while the rest of the world proceeds ahead in financial market innovation.

The application of certain CFTC rules threatens jobs in the US financial services industry. As explained above, the CFTC’s November 2013 Staff Advisory imposed swaps transaction rules on trades between non-US persons whenever anyone on US soil “arranged, negotiated, or executed” the trade.92 While the Staff Advisory has been delayed for the fourth time, it is causing many overseas trading firms to consider cutting off all activity with US-based trade-support personnel to avoid subjecting themselves to the CFTC’s flawed swaps trading rules.93 The Staff Advisory jeopardizes the role of bank sales personnel in US financial centers like Boston, Charlotte, Chicago, New Jersey and New York. It will likely have a ripple effect on technology staff supporting US electronic trading systems, along with the thousands of jobs tied to the vendors who provide food services, office support, custodial services and transportation to the US financial services industry. With tens of millions of Americans falling back these days on part-time work, the CFTC should not cause good-paying full-time jobs to be eliminated.94

The swaps rules also appear to contain an unstated bias against human discretion in swaps execution. The bias is seen in a range of CFTC positions, such as:

- Allowing only two specific types of execution methods for Required Transactions;95
- Requiring an RFQ System to operate in conjunction with an Order Book.96

92 CFTC Staff Advisory No. 13-69.
95 17 C.F.R. 37.9(a)(2).
96 Id. and 17 C.F.R. 37.9(a)(3).
• Requiring an RFQ to be sent to three market participants;\(^\text{97}\)
• Placing various conditions around basis risk mitigation services;\(^\text{98}\) and
• Showing aversion to Dutch Auction systems that utilize professional discretion in setting auction prices.\(^\text{99}\)

Yet, there is just no legal support in Title VII of Dodd-Frank for restricting human discretion in swaps execution.

Is it not odd that, while the CFTC has been restrictive of human interaction in swaps markets, the US’s most successful financial marketplace – the IPO market – is trumpeting the importance of “human touch” in its market?\(^\text{100}\) They assert the human element as a key safeguard against the type of runaway technical errors that plagued Facebook’s 2012 IPO, when more than 30,000 buy and sell orders were either canceled or delayed.\(^\text{101}\) It would be a regulatory failure to restrict human involvement and interaction in the $691 trillion swaps markets and herd trading onto automated electronic platforms, where software failures and technical glitches could someday cause a “flash crash” unlike anything yet seen in global markets.

In a peculiar twist, the CFTC’s insistence upon RFQ systems and centralized, order-driven markets to execute swaps transactions has the potential to open US swaps markets to algorithmic and high-frequency trading (HFT), which are not currently a factor in swaps markets. It is unclear how those who support the CFTC’s impetus for electronic central limit order book (CLOB) execution of swaps, yet decry HFT in today’s equities and futures markets, will reconcile these views when the enormous but human-managed swaps markets are launched into unmanned hyperspace by HFT algorithmic trading technologies.

For these reasons and more that I have set out in my White Paper, I am of the firm view that key elements of the CFTC swaps trading rules:

• Do not accord with congressional intent;
• Have not enhanced market transparency; and
• Have not decreased the systemic risk that the Dodd-Frank Act was premised on reducing.

C. A Swaps Trading Regulatory Framework Consistent with Title VII of Dodd-Frank

I have proposed an alternative swaps trading regulatory framework that is pro-reform and fully aligned with the express statutory framework of Title VII of the Dodd-Frank Act. My proposed swaps regulatory framework is built upon five key tenets:

• Comprehensiveness;
• Cohesiveness;

\(^\text{97}\) 17 C.F.R. 37.9(a)(3).
\(^\text{99}\) Apparently, an objection of the CFTC staff to Dutch Auction swap execution is that brokers have discretion in finding price points at which to commence an auction.
\(^\text{101}\) Id.
• Flexibility;
• Professionalism; and
• Transparency.

The first tenet is to subject a comprehensive range of US swaps trading activity to CFTC oversight. My approach supports the CFTC’s broad SEF requirement for registration, but insists that the scope of regulatory coverage be fully set forth in clear and definitive rule text and not buried in footnotes, staff advisories or no-action letters.

As of April 9, 2015, CFTC staff has had to issue 258 no-action letters, 56 exemptive letters and 43 statements of guidance, interpretation and advice to implement the Dodd-Frank mandates. That is a total of 357 – and counting – miscellaneous communications without formal CFTC rulemaking. There is something clearly wrong with our swaps regulatory framework if it requires that much staff work to put it in place. We need a better set of rules.

The second tenet is regulatory cohesiveness. We must remove the CFTC’s artificial slicing and dicing of swaps markets. We must do away with these odd categories of Required Transactions and Permitted Transactions and with block transactions “off-SEF” and non-blocks “on-SEF.” Instead, all CFTC-regulated swaps trading should fall within the same cohesive and undivided regulatory framework.

The third tenet is flexibility. The CFTC must adhere to Dodd-Frank’s express prescription for flexibility in swaps trading. That means that swaps market participants must be allowed to choose from the broadest possible array of methods of swaps execution that comply with the statutory SEF definition. Those include:

• Electronic CLOBs;
• Simple order books;
• RFQ systems;
• Electronic Dutch Auctions;
• Hybrid electronic and voice execution methods;
• Full voice-based execution methods; and
• Work-up.

It also includes any other “means of interstate commerce” that may today or someday in the future satisfy swaps customer trading and liquidity requirements. US swaps markets must be reopened to business and technological innovation. Technology is improving American lives today in many ways, from hailing a taxi with Uber to connecting with business colleagues on LinkedIn. Technological innovations are also transforming capital markets in areas such as raising money for business start-ups through Kickstarter and consumer borrowing through Payoff. These innovations lower barriers to entry, reduce costs and open markets to a broader range of participants. Unfortunately, the CFTC’s swaps rules would prevent such technological innovation in the US swaps markets.

Customer choice and technological innovation, not regulators, must determine the various means of interstate commerce utilized in the swaps market. That is clearly what Congress intended. That is surely the American way.

102 17 C.F.R. 37.3(a)(1); SEF Rule at 33,481-83.
103 CEA section 1a(50); 7 U.S.C. 1a(50).
As I have recommended, the CFTC should do away with its unworkable MAT process, which is not authorized by Dodd-Frank. Yet, eliminating the MAT process will only work if SEFs are allowed to offer swaps execution through “any means of interstate commerce.” This approach would also give a plain reading to the requirement for impartial access that does not confuse it with a mandate for open access. Dodd-Frank did not call into being any particular swaps market structure, such as existing separate dealer-to-dealer and dealer-to-customer markets or combined all-to-all markets. Therefore, regulators must leave participants in the marketplace to determine the optimal market structure based on their swaps trading needs and objectives.

This approach would also better accommodate established and beneficial swaps market practices. It would allow SEFs to implement clear, workable error-trade policies to address the situation where an executed swaps transaction is rejected from clearing. It would end the void ab initio policy, which is not statutorily sound. The proposal would further treat the SEF core principles as true principles as Congress intended and not as rigid rule sets.

The fourth tenet of my alternative framework is to enhance professionalism in the swaps market by setting standards of conduct for swaps market personnel. This is consistent with the current approach of advanced overseas regulators, such as the UK’s Financial Conduct Authority, that look to supervise professional behavior in overseas financial markets. Rather than implementing highly prescriptive swaps trading rules here in the US that limit intermediaries’ discretion, my approach is to establish standards that would enhance the knowledge, professionalism and ethics of personnel in the US swaps markets who exercise discretion in facilitating swaps execution.

It is remarkable that today, if you want to trade a share of Microsoft, you go to a broker who has passed a Series 7 exam confirming his or her product knowledge, skills and abilities in the marketplace. If you want to trade corn futures on the CME you may speak to an IB who has passed the Series 3 exam confirming his or her futures-markets proficiency. Yet, brokers handling billion-dollar CDS and interest-rate swap trades are not required to pass any exams whatsoever.

In the US there is currently no standardized measurement of one’s knowledge and qualification to act with discretion in the largest and, arguably, most systemically important financial market — swaps. My proposal would look to established precedents, such as the NFA’s Series 3 exam and rules for IBs and other members, as well as FINRA’s Series 7 exam and rules for broker-dealers, as guides and modify them to apply to swaps trading and markets.

But enhancing the professionalism of swaps brokers is only worth doing if they are allowed to exercise professional discretion in flexible methods of swaps execution as Congress intended. It is surely pointless and unsupportable otherwise.

The last tenet of my framework focuses on promoting swaps trading and market liquidity as a prerequisite to increased transparency. To date, pre-trade price transparency has been greatly emphasized to the detriment of liquidity in the swaps trading rules. Yet, no meaningful increase

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in swaps market transparency has been achieved by CFTC rules requiring Order Books that few are using. Requiring Order Books was not how Dodd-Frank balanced the goals of SEF trading.

The right way to promote price transparency is through a proportioned focus on promoting swaps trading and market transparency, as Congress intended. Instead of taking a prescriptive approach to swaps execution that drives away participants, this framework would allow the market to innovate and provide execution through “any means of interstate commerce.” That way, participants could choose the execution method that meets their needs based upon a swap’s liquidity characteristics, which in turn, would promote trading on SEFs and liquidity. In other words, promoting swaps trading and market liquidity will lead to the enhanced price transparency that Congress sought to achieve.

Many of the adverse consequences of the CFTC’s swaps trading rules could be reversed if the rules were redesigned to be much simpler and more effective and if they were in accord with the clear provisions of Title VII of the Dodd-Frank Act.

A smarter and more flexible swaps regulatory approach would eschew the artificial slicing and dicing of US trading liquidity and unwarranted restrictions on means of execution that are unsupported by the law. Rather, it would enable the US to take the global lead in measured and smart regulation of swaps trading. It would allow American businesses to more efficiently hedge commercial risks, promoting economic growth. It would stimulate the American economy and job creation.

For decades the CFTC has been a competent and effective regulator of US exchange-traded derivatives. The opportunity is at hand to continue that excellence in regulating swaps markets. It is time to seize that opportunity.

IV. Cross-Border Impact of Derivatives Regulation

At the 2009 Pittsburgh G-20 Summit, global leaders agreed to work together to support economic recovery through a “Framework for Strong, Sustainable and Balanced Growth.”\footnote{G-20 Leaders’ Statement, The Pittsburgh Summit at 2 (Sept. 24-25, 2009) (G-20 Statement), available at http://www.treasury.gov/resource-center/international/g20/Documents/pittsburgh_summit_leaders_statement_200909.pdf.} The G-20 leaders agreed upon three fundamental principles\footnote{In addition, the G-20 leaders agreed on a fourth principle: that non-centrally cleared derivatives should be subject to higher capital requirements.} for OTC derivatives markets: (1) moving many bilateral swaps to CCPs for clearing; (2) where appropriate, trading all standardized OTC derivative contracts on regulated trading platforms; and (3) reporting swap trades to trade repositories.\footnote{G-20 Statement at 9.} To achieve these common goals, the Pittsburgh participants pledged to work together to “implement global standards” in financial markets, while rejecting “protectionism.”\footnote{Id. at 7.} I am pleased to note that Chairman Massad and CFTC staff, especially the CFTC’s Division of Clearing and Risk, have made it a priority to work constructively and collaboratively with our international counterparts to achieve the goals set out in the G-20 commitments. Yet, many challenges remain in coordinating global efforts to reform the derivatives markets.
A. Clearinghouse Recognition and Regulation

One of the most critical cross-border issues currently facing the CFTC is US clearinghouse recognition by the European Commission. The EC has not recognized US CCPs as equivalent under the European Market Infrastructure Regulation (EMIR), as it has for CCPs in Japan, Hong Kong, Australia and Singapore.\(^\text{110}\) If the EC does not recognize US CCPs as equivalent by June 15, 2015, they will not be classified as “qualifying” CCPs for purposes of Basel III risk-weighting for banking institutions. This will make it cost-prohibitive for EU banks to clear through US CCPs, which will be unable to maintain direct clearing member relationships with EU firms and will be ineligible to clear contracts subject to the EU clearing mandate later this year.\(^\text{111}\)

Needless to say, this outcome will be destructive to both US and European economic interests and lead to further market fragmentation and contraction of liquidity, market disruption and dislocation in the global derivatives markets.

This issue remains unresolved despite the fact that the US has adopted global clearing standards. The CFTC adopted the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs) in December 2013.\(^\text{112}\) The CFTC also patterned its swaps clearing rules on its rules for clearing futures, which have worked successfully for decades.\(^\text{113}\) The CFTC’s rules do not require that swaps clearing take place in the United States, even if the swap is in US dollars and between US persons. But the CFTC does require that swaps clearing take place on a CFTC-registered and supervised clearinghouse or CCP that meets core principles and basic standards, including the PFMIs. The CFTC’s approach is drawn from its successful record of respecting the integrity of the parallel regulatory regimes that govern the clearing activities of dually registered US-EU CCPs.\(^\text{114}\)

Yet, this lack of coordination in swaps clearing does not exist in a vacuum. It follows on the heels of an uncoordinated approach to the regulation of swaps trading.

B. Swaps Trading

I believe the CFTC started the current rift in cross-Atlantic swaps cooperation with its July 2013 “Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations” (Interpretive Guidance).\(^\text{115}\) In essence, the Interpretive Guidance asserted that every single swap a US person enters into, no matter where it is transacted, has a direct and


\(^{111}\) Article 4(88) of the EU Capital Requirements Regulation provides that a CCP is not qualified unless it is authorized in accordance with Article 14 of EMIR or recognized pursuant to Article 25 of EMIR. Pursuant to EU CRD IV, trades cleared with a non-qualified CCP are subject to significant capital charges.

\(^{112}\) CFTC regulations have fully implemented the PFMIs. See Derivatives Clearing Organizations and International Standards, 78 FR 72,476 (Dec. 2, 2013).


\(^{114}\) The CFTC has not required that dually registered US-EU CCPs apply what is referred to as the “FCM” or “agency” model of clearing to intermediaries that are not CFTC-registered FCMs. This enables the non-US intermediaries of dual registrants to continue to clear “back-to-back” transactions. Similarly, while CFTC regulations prohibit a registered CCP from imposing a minimum capital requirement of more than $50 million on clearing members, the CFTC does not require that US-EU dual registrants apply this standard to non-US and non-FCM clearing members.

\(^{115}\) 78 FR 45,292 (Jul. 26, 2013).
significant connection with activities in, and effect on, commerce of the United States, which requires imposing transaction rules of the CFTC.

Several months later, the CFTC issued a “Staff Advisory” that declared that, even if no US person is a party to the trade, CFTC trading rules apply if it is “arranged, negotiated, or executed” by personnel or agents of a non-US swap dealer located in the US.\footnote{116 CFTC Staff Advisory No. 13-69 (Nov. 14, 2013), available at http://www.cftc.gov/ucm/groups/public/@freetextdocuments/documents/letter/13-69.pdf.}

Taken together, these CFTC pronouncements say that CFTC trading rules apply anytime and anywhere a US person is a party to a swaps trade or the trade is assisted from US shores.

Making things worse, the CFTC swaps trading rules contain a host of peculiar limitations based on practices in the US futures markets that I have describe in my January 29, 2015 White Paper and are summarized elsewhere in this Testimony. Many of these limitations have not been adopted in the EU\footnote{117 Consultations are still underway under MiFID II and MiFIR.} or anywhere else. Several of these peculiar CFTC swaps trading rules are contrary to common practice in global markets and are unlikely to be replicated by non-US regulators.

The combined effect of the CFTC’s Interpretive Guidance and Staff Advisory\footnote{118 In addition, the Division of Market Oversight issued Guidance on November 15, 2013, stating that it “expects that a multilateral swaps trading platform located outside the United States that provides U.S. persons or persons located in the U.S. (including personnel and agents of non-U.S. persons located in the United States) … with the ability to trade or execute swaps on or pursuant to the rules of the platform, either directly or indirectly through an intermediary, will register as a SEF or DCM.” Division of Market Oversight, Guidance on Application of Certain Commission Regulations to Swap Execution Facilities at 2 (Nov. 15, 2013), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmosefguidance111513.pdf.} – neither of which is a formally adopted CFTC rule – is to dictate that non-US market operators and participants must abide by the CFTC’s peculiar, one-size-fits-all swaps transaction-level rules for trades involving US persons or supported by US-based personnel.

The avowed purpose of the CFTC’s broad assertion of jurisdiction is to insulate the United States from systemic risk. Yet, on the ostensible grounds of ring-fencing the US economy from harm, the CFTC purports to tell global swaps markets involving US persons to adopt particular CFTC trading mechanics that do almost nothing to reduce counterparty risk. In the words of one former senior CFTC advisor, the Interpretive Guidance “yoked together rules designed to reduce risk with rules designed to promote market transparency. Yet it provided almost no guidance about how to think about the extraterritorial application of market transparency rules independent of risk. As a result, [the CFTC prescribed] how to apply US rules abroad based on considerations that are tangential to the purposes of those rules.”\footnote{119 Timothy Karpoff, The Smart Way to Regulate Overseas Swaps Trading, American Banker (Jul. 21, 2014), available at http://www.americanbanker.com/bankthink/}

C. Market Fragmentation

This uncoordinated approach to the regulation of swaps execution and the CFTC’s problematic swaps trading regulations have fragmented global markets. Traditionally, users of swaps products chose to do business with global financial institutions based on factors such as quality of service, product expertise, financial resources and professional relationship. Now, those criteria are secondary to the question of the institution’s regulatory profile. Non-US person market participants are avoiding financial firms bearing the scarlet letters of “US person” in
certain swaps products to steer clear of the CFTC’s problematic regulations. Non-US person market participants’ efforts to escape the CFTC’s flawed swaps trading rules are fragmenting global swaps markets between US persons and non-US persons and driving away global capital.

Since the start of the CFTC’s SEF regime in October 2013 and accelerating with mandatory SEF trading in February 2014, global swaps markets have divided into separate trading and liquidity pools between those in which US persons are able to participate and those in which US persons are shunned. Liquidity has been fractured between an on-SEF, US person market on one side and an off-SEF, non-US person market on the other.

According to a survey conducted by the International Swaps and Derivatives Association (ISDA), the market for euro interest-rate swaps (IRS) has effectively split.120 Volumes between European and US dealers have declined 77 percent since the introduction of the US SEF regime.121 The average cross-border volume of euro IRS transacted between European and US dealers as a percentage of total euro IRS volume was 25 percent before the CFTC put its SEF regime in place and has fallen to just 9 percent since.122

Rather than controlling systemic risk, the fragmentation of global swaps markets into regional ones is increasing risk by Balkanizing pools of trading liquidity and market pricing.

With the CFTC’s swaps trading regime dividing trading in global swaps markets between US persons and non-US persons, we cannot risk further dividing US and European markets in derivatives clearing. That would be the effect if the EC does not recognize US CCPs as equivalent under EMIR.

Now, I can fully understand if some observers of the European resistance to CCP equivalence are reminded of the old idiom, “turnabout is fair play.” If the American regulators can overreach when it comes to swaps execution, why should European regulators not overreach on swaps clearing?

D. The Smoot-Hawley Tariff Act of 1930

I have previously likened the current circumstance to the situation after passage by the US Congress of the infamous Smoot-Hawley Tariff Act of 1930, which steeply hiked tariff rates on

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120 See International Swaps and Derivatives Association, Revisiting Cross-Border Fragmentation of Global OTC Derivatives: Mid-year 2014 Update, ISDA Research Note (Jul. 2014) (ISDA Update), available at http://www2.isda.org/functional-areas/research/research-notes/. See also Phillip Stafford, US Swaps Trading Rules Have "Split Market," Financial Times (Jan. 21, 2014), available at http://www.ft.com/intl/cms/s/0/58251f84-82b8-11e3-8119-001444f8807c.html#axzz3CHQbMKxU. Beginning in October 2013 after the SEF rules compliance date, European dealers began to trade exclusively with other European counterparties in the market for euro IRS and dramatically moved away from trading with US counterparties. Since October 2013, 91 percent of euro IRS trades take place between two European counterparties, while only 9 percent occur between a US and a European dealer. By May 2014, 94 percent of euro IRS trades were between two European counterparties, while only 6 percent of euro IRS trades were between a European and US counterparty. Compare these figures to those from a month before the SEF rules’ compliance date, when 71 percent of euro IRS trades were between two European counterparties and 29 percent between a US and European dealer. This has been a clear shift in trading behavior for European dealers. This observation is also supported by an ISDA survey wherein 68 percent of non-US market participant respondents indicated that they have reduced or ceased trading with US persons. ISDA Update.

121 ISDA Update.

122 Id.
over 3,300 categories of imported agricultural and manufactured goods.\textsuperscript{123} Smoot-Hawley came into effect just as the United States was descending into the Great Depression. Promoters of the law said it was necessary to raise US agricultural prices and help American farmers.\textsuperscript{124} They gave little consideration to what the international reaction would be to the higher tariffs.\textsuperscript{125}

Smoot-Hawley did not cause America’s Great Depression, but it made it worse than it might otherwise have been by contracting both US imports and exports and inviting harsh retaliation.\textsuperscript{126} It surely failed in its promised objective of increasing US farm income.\textsuperscript{127}

Instead, through Smoot-Hawley the US abdicated economic leadership and poisoned commercial relations with its major trade partners.\textsuperscript{128} Smoot-Hawley was interpreted as a declaration of trade war at a critical time in the world economy. Smoot-Hawley made the US a special target of discriminatory trade retaliation from some of the US’s largest and most important trade partners.\textsuperscript{129} It led other countries to form preferential trading blocs that discriminated against the United States, diverting world trade and delaying economic recovery on both sides of the Atlantic.\textsuperscript{130}

The formation of European trading blocs failed to stem Europe’s trade deterioration. Rather, this development worsened Europe’s economic decline through the 1930s, culminating in a devastating world war and the annihilation of Europe’s economy. This trade war was not fully reversed until the General Agreement on Tariffs and Trade a decade later.

\textbf{E. Return to the Spirit of the Pittsburgh Accords}

The EC and CFTC must develop a cross-border regulatory relationship in the spirit of the Pittsburgh G-20 accords. This relationship is necessary to avoid a trade war in financial markets akin to that which worsened the Great Depression.

A trade war over swaps market clearing and execution will be harmful for the US. As the world’s largest economy and largest debtor, the US must retain deep and liquid capital markets if it is to maintain its reserve currency status and its standard of living. Unfortunately, fragmentation of global swaps markets between US persons and non-US persons means smaller and disconnected liquidity pools and less efficient and more volatile pricing for market participants and their end-user customers. It also means greater risk of market failure in the event of economic crisis. By Balkanizing global swaps liquidity, the CFTC’s Interpretive Guidance is actually increasing the systemic risk that it was predicated on reducing. Like Smoot-Hawley, the CFTC’s Interpretive Guidance is ill-suited to its ostensible purpose of systemic risk reduction. It is, however, wreaking havoc and forcing US financial institutions to retreat from what were once global markets. We simply cannot allow uncoordinated regulatory reforms to permanently divide global swaps markets between US and non-US persons.

\textsuperscript{124} \textit{Id.} at 18-23.
\textsuperscript{125} \textit{Id.} at 145.
\textsuperscript{126} \textit{Id.} at 142-143.
\textsuperscript{127} \textit{Id.} at 218.
\textsuperscript{128} \textit{Id.} at 152.
\textsuperscript{129} \textit{Id.} at 183.
\textsuperscript{130} \textit{Id.}
Similarly, a trade war in swaps markets will be a disaster for Europe. The EU has a serious growth problem. Except for Japan, the EU has had the weakest economic growth in the industrialized world.\textsuperscript{131} In the words of Francois Heisbourg, “The world is advancing, but not Europe.”\textsuperscript{132} European Central Bank President Mario Draghi has highlighted that EU governments need to implement structural reforms to increase sustainable growth and encourage investment in the euro zone.\textsuperscript{133} Mr. Draghi’s warning may be of little help if the debate over clearing equivalence remains unresolved, hampering business access to liquid markets for hedging of investment risk.

Undeniably, the EU is in desperate need of investment in economic development and job creation. European investment capital comes overwhelmingly from banks. European banks are significant participants in the US derivatives markets, and the EU banks cannot afford to retreat from those markets.

Moreover, the process of bank deleveraging and overstretching of national governments mean that Europe must look to a broader array of financing sources available in modern global financial systems, including private lending, securitized credit and private equity. To avail itself of these options, the EU must assure US capital access to European risk-hedging markets. According to CFTC data, trading volume on European futures exchanges relies to a considerable extent on direct access from the US. EU markets cannot afford to jeopardize this US trading volume. Denying equivalence to US CCPs will not cure Europe’s stagnant economic growth – it will worsen it.

We must not let the current cross-border impasse over swaps markets persist and thwart European growth and, in turn, lead Europeans to conclude that the EU is not part of the solution but part of the problem.

Flourishing capital markets are the answer to US and European 21\textsuperscript{st} century economic woes, not trade wars and protectionism. The solution to sluggish growth in the developed economies is safe, sound and vibrant global markets for investment and risk management. We must maintain liquid and broad global derivatives markets. To do so, we must reach an accord on how to regulate derivatives execution and clearing in a harmonious manner across jurisdictions.

The CFTC is continuing its dialogue with the Europeans to facilitate their recognition of our clearinghouses as equivalent. Work continues on both sides to establish a sound and practical basis for regulatory and supervisory cooperation. As both sides work through differences to find common – and solid – ground, it remains critically important to provide certainty to CCPs and market participants to prevent any potential disruption to their businesses.

But we can go further. The CFTC must replace its cross-border Interpretive Guidance with a formal rulemaking that recognizes outcomes-based substituted compliance for competent non-US regulatory regimes. I support the withdrawal of the CFTC staff’s November 2013 Advisory that fails not only the letter and spirit of the “Path Forward,” but also contradicts the conceptual underpinnings of the CFTC’s Interpretive Guidance.

\textsuperscript{131} Francois Heisbourg, La Fin du Reve European (the End of the European Dream) (Editions Stock 2013).
\textsuperscript{132} Id.
V. CFTC Resources and Budget

I want to thank Congress for the increase to the CFTC’s budget for FY 2015. In fact, as Chairman Aderholt noted at the CFTC FY 2016 Budget Hearing in February of this year, the CFTC’s spending has increased 123 percent since the Financial Crisis of 2008.\textsuperscript{134} This significant increase is all the more appreciated given the nation’s substantial debt. I realize the challenges Congress faces in allocating scare resources among agencies seeking increased funding to support their missions. I also realize that the CFTC must make a compelling case, and efficiently utilize existing resources, in order to justify further increases.

In this regard, the CFTC could be doing more. For example, managing the CFTC’s flawed swaps trading regulatory framework is expensive and time-consuming. Fitting the square peg of the CFTC’s swaps trading rules into the round hole of the established global swaps markets requires the Commission and staff to devote enormous resources to continuously explain, clarify, adjust, exempt and manipulate rules to allow rough swaps market operability. The Commission and staff must constantly add to the plethora of no-action letters, guidance, staff advisories and other written communications that go out to the market and participants. During the course of implementing the Dodd-Frank Act, the CFTC staff has issued 357 such communications.\textsuperscript{135} The CFTC’s current swaps trading regulatory framework requires enormous bureaucratic “make work” to assure industry compliance. Yet, it is mostly unnecessary and unsupported by Title VII of the Dodd-Frank Act. It wastes taxpayer dollars at a time when the CFTC is seeking additional resources from Congress.

Similarly, the CFTC’s proposed position limits rules are overly burdensome and will require substantial agency resources to implement and sustain. They do nothing to leverage the decades of experience and large existing staffing capabilities of the major US DCMs. Instead, the CFTC’s proposed position limits rules would partially duplicate – at US taxpayer expense – the management of position limits already being done by DCMs at industry expense.

The CFTC should work to reduce these and other examples of inefficiencies before asking for substantial budget increases. I will work to make sure that the CFTC is using its resources wisely. However, let me be clear. These comments are not meant to criticize the CFTC staff. The CFTC has a dedicated, professional staff who have been working hard to implement the Dodd-Frank Act and carry out the agency’s existing responsibilities. The CFTC is fortunate to have such a staff to fulfill the agency’s mission in service to the American public.

Conclusion

The CFTC has accomplished much since the passage of the Dodd-Frank Act, but many challenges remain. The CFTC must do more to reduce the regulatory burdens on end-users. The CFTC must make sure that our rules do not treat end-users as though they were the cause of the financial crisis. The CFTC must revisit its swaps trading rules and fully align them with the clear provisions of Title VII of the Dodd-Frank Act. Not doing so will continue to drive away market participants, harming swaps market liquidity and increasing market fragility. Finally, the CFTC and foreign regulators must redouble their efforts to cooperate and harmonize their

\textsuperscript{135} As of April 9, 2015, the CFTC staff has issued 258 no-action letters, 56 exemptive letters and 43 staff interpretive letters, guidance, advisories and other written communications.
regulations to preserve the global market for swaps trading. Without such efforts, market fragmentation will continue and systemic risk will increase, hurting global markets and growth.

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