U.S. COMMODITY FUTURES TRADING COMMISSION
ENSURING THE INTEGRITY OF THE FUTURES & OPTIONS MARKETS

SPEECHES & TESTIMONY

Remarks of Chairman Timothy G. Massad before the Futures Industry Association Expo 2014

November 5, 2014

As Prepared For Delivery

Thank you for inviting me today, and I thank Walt for that kind introduction. I also want to acknowledge the work that the Futures Industry Association and its members have done. There are many examples of your contributions, from the recent SEF Tracker to your longstanding commitment to customer protection.

I appreciate your input on all of the issues facing the Commission and look forward to continuing to work with you.

I spent 5 years immediately prior to this job helping our nation recover from the worst financial crisis since the Great Depression. That experience makes it easy to remember why we are implementing reforms of the derivatives market in the first place. We must never forget the true cost of the crisis: eight million jobs lost, millions of foreclosed homes, countless retirements and college educations deferred, and businesses shuttered.

My perspective is also shaped by my work as a lawyer in the private sector for 25 years before joining Treasury. I worked with businesses and governments all over the world on all types of transactions. And as a young lawyer, I was part of a small group that drafted the original ISDA master agreements in the late 1980s as well as related documents such as the code of definitions and the user's guide. I then went on to advise clients periodically on derivatives matters. And so I appreciate the importance of these markets to a wide variety of businesses.

Implementing the New Regulatory Framework

The financial crisis made clear the need for reform of the derivatives markets. I would like to begin by reviewing our progress to date, and then discuss a few priorities going forward.

Let's look at where we are on the four key commitments embodied in the Dodd-Frank Act and agreed to by the leaders of the G-20 nations to bring the over-the-counter derivatives market out of the shadows:

- Increased oversight of major market players. Today, we have 106 swap dealers and 2 major swap participants provisionally registered, and we require them to observe strong risk management practices and business conduct standards.
- Clearing of standardized transactions. Clearing is now required for most interest rate and credit default swaps. In December 2007, only 16% of outstanding transactions, measured by notional value, were cleared according to industry estimates. In September, 74% were cleared. An estimated 86% of index credit default swaps were cleared.
- Transparent trading of standardized transactions on regulated platforms. Today, there are 22 swap execution facilities temporarily registered, and 2 applications are pending. SEF trading is new, there are issues to work out, but use continues to increase. Total notional traded volume on SEFs is up 42% in September versus August. And volumes in October are up again another 11%.

And finally:

- Regular reporting for increased market transparency. This is also a work in progress, but today we and the public have much more information regarding the swaps marketplace, enabling more competition and better oversight.

The CFTC has written almost all of the rules the Dodd-Frank Act required, and leads all other G-20 nations in implementing these reforms.

How far we have come is a credit to the hardworking professional staff of the CFTC and my predecessor, former Chairman Gary Gensler. We would not be where we are today without their dedication and tireless efforts.

Our focus now and going forward is to finish the Dodd-Frank rules, make sure they work as intended, and enforce them.

There are some rules we need to complete.

In September, we reproposed our rule on margin for uncleared swaps. While central clearing is a key mandate of the Dodd-Frank Act, uncleared, bilateral swap transactions will continue to be a large part of the derivatives market. So, margin will continue to be a significant tool to mitigate the risk of default, and therefore, the potential risk to the financial system as a whole.

We worked closely with the bank regulators so that our respective rules are substantially the same. Our proposal exempts end-users from the requirements, and on this point they adopted our approach. We look forward to reviewing comments on the proposed rule.

The capital rule and position limits rule are two others that we are actively working on. Congress mandated that we implement position limits to address the risk of excessive speculation. But in doing so, we must make sure that the market works for commercial end-users seeking to hedge routine risk through bona fide hedging. We have received substantial public input on this rule, and we are going to take our time to get it right.

We have also been focused on fine-tuning some of our rules to make sure they work as intended and do not impose unintended consequences, particularly for nonfinancial commercial companies. These are not major changes, but they are significant in making sure that manufacturers, farmers, ranchers, and other companies that rely on the derivatives markets to hedge routine business risks can continue to use them efficiently and effectively. This process is to be expected with reforms as significant as these.

In September, the Commission amended its rules pertaining to special entities, so that local, publicly-owned utility companies could continue to effectively hedge their risks in the energy swap market, which they must do to provide reliable, cost-effective service to their customers.

This week, we proposed three additional small changes: First, to revise our rules to clarify that the deadline for futures commission merchants to post “residual interest” will not move to earlier than 6:00 pm without affirmative Commission action and an opportunity for public comment. Second, to revise Regulation 1.35(a) to codify previously granted no-action relief that exempts end-users and commodity trading advisors from certain recordkeeping requirements related to text messages and phone calls; it also clarifies for all participants the requirement that records be searchable. And, third, to clarify our interpretation of when an agreement, contract, or transaction that contains embedded volumetric optionality falls within the forward exclusion from being considered a swap.

I also wish to announce that CFTC Staff have recommended extending the no-action relief previously provided in order to phase-in the requirement to trade on SEFs swaps executed as part of certain package transactions—that is, transactions involving a swap that is required to be traded on a SEF and some other swap or other product. Over the last year, we have been phasing in the trading requirement as it pertains to swaps that are part of various types of packages. We recognize the market needs a bit more time on certain remaining packages, and I expect the staff will issue the letter shortly.

Cross Border

Let me now turn to where we are on cross-border issues. I think everyone here understands the importance of creating a global framework for the regulation of swaps.

I know many of you are concerned about potential inefficiencies if there are significant differences in the derivatives reforms adopted by different jurisdictions. I share the desire for creating an international regulatory framework that is as similar as possible across national boundaries. But, I think it is important to have some perspective. How many of you expect the rules as to how you sell securities to be the same in all the G-20 nations? If you have worked on a public offering, you know they are not. Or how about the rules for securing bank loans. Those aren’t even the same in the 50 states. So let’s remember that we are in a unique historical situation: the OTC derivatives industry grew up to be a global industry without any oversight or national regulation. Now, as the financial crisis exposed weaknesses in this global market we are seeking to regulate it through the actions of the various G-20 nations, each of which has its own legal traditions, regulatory philosophy, administrative process, and political dynamics. Although the G-20 nations have agreed on basic principles for regulating swaps, there will inevitably be differences in the specific rules as reforms are implemented, including in timing of implementation. This is something I regard as a glass half full, not half empty. We are making progress, but it will take time.

Indeed, the timing of implementation of reforms alone is a simple but critical issue in solving these cross-border issues. We wrote most of our rules faster than other jurisdictions and made many substituted compliance determinations last December. More will eventually follow. But you can’t make substituted compliance determinations until other jurisdictions have written their rules or passed their laws.

We have recently focused on cross-border issues in the context of the margin rule, where we are considering different options as to how to apply the rule outside our boundaries. And we are working to make the rules on margin being considered in the U.S., Europe, and Japan very similar in the first place.

We at the CFTC are also aware that the no-action relief that was granted with respect to the further cross border guidance we issued last November 14 will expire at the end of the year. This pertains to when a foreign swap dealer that engages in certain conduct in the United States is subject to U.S. transaction requirements. Earlier this year, the Commission asked for comment on that advisory. We are still considering those comments, as well as the relationship of this issue to other cross-border issues. Therefore, the staff is recommending that we extend this relief for the time being, and I support that recommendation so that we have the necessary time to consider these issues.

As a general matter, I believe physical presence or conduct in the U.S. has long been a traditional basis for jurisdiction. In considering how to apply that jurisdictional standard, we must consider what regulatory goals are intended to be served. Different aspects of our requirements address different regulatory goals, such as protecting our economy against the importation of risk from abroad or insuring that our markets function with integrity and transparency. In addition, we should strive for rules that are clear and predictable – and that, as much as possible, do not create negative effects on competition.

Let me also say a few words about cross-border harmonization when it comes to the regulation of clearinghouses. We are continuing to work with the European Union on this issue. As you know, the Europeans have not yet recognized our central clearinghouses as equivalent. Their law, EMIR, requires not only that our rules governing our clearinghouses meet international standards – which they do – but also that our laws have an effective system of recognition for clearinghouses located in Europe. That has led us to discuss the rules governing clearinghouses that are located in Europe, but are also registered with the CFTC. There are presently three such clearinghouses.

This dual registration came about because the U.S. did not mandate that clearing of futures —even futures traded on U.S. exchanges—must take place in the U.S.; we simply required that it take place through clearinghouses that are registered with us and that meet our standards. Those standards include provisions related to our bankruptcy laws. They provide protection of customer funds and facilitate quick transfers of customer accounts in the event of a failing firm.

We built our swap clearing mandates on this framework of dual registration, and as a result, clearing of swaps for U.S. persons largely takes place overseas. One European clearinghouse, for example, has been dually registered with us since 2001. It handles most of the market for swap clearing, and a majority of that clearing is for US persons.

We continue in dialogue with the Europeans to facilitate their recognition of our clearinghouses. And, we have agreed to consider changes that would further harmonize our rules with European rules governing these clearinghouses. This would in turn facilitate their recognition of our U.S. clearinghouses. In the meantime, I am pleased that the European Commission has decided to postpone the imposition of higher capital charges on banks clearing through U.S.-based central counterparties. It was this threat of higher capital charges that was going to fragment the market, not the existence of dual registration, which has actually been the foundation for the growth of the global market.

Dual registration and cooperative supervision has worked. In addition, I believe it is a good approach as a matter of public policy because major clearinghouses are extremely important in the global financial system today. We have made them more important as a result of the global reforms to the OTC derivatives market. I believe everyone here understands that, while clearinghouses are a good way to monitor and mitigate the risk of transactions that would otherwise be conducted on a bilateral basis, they do not eliminate risk. That's why we are working closely with the Federal Reserve now on major clearinghouse issues. Regulators must work together to make sure clearinghouses operate transparently, meet necessary standards and safeguards, and do not pose risks to financial stability. We must also make sure that central clearinghouse contingency planning is sufficient.

Cybersecurity

An increasingly important aspect of our oversight of CCPs, as well as exchanges and other key institutions that we regulate, is cybersecurity and business continuity disaster recovery generally. The need to strengthen the security and resilience of our financial markets against cyber attacks is clear.

We are all aware of the risk. The examples from within and outside the financial sector are

all too frequent and familiar: the latest include JP Morgan; Home Depot and Target. Some of our nation's exchanges have also been hit or suffered other technological problems that caused outages or serious concerns.

And because of the interconnectedness of financial institutions and markets, a failure in one institution can have significant repercussions in the system.

So let me talk about what we are doing regarding cybersecurity and business continuity disaster recovery at the CFTC.

Our Core Principles have been modernized in recent years to address cyber and information security. Our regulations for clearinghouses, exchanges and other market infrastructure entities have similarly been updated by adding more detailed standards addressing various aspects of cyber security.

Our system safeguards require these entities to have four important things: first, a program of risk analysis and oversight to identify and minimize sources of cyber and operational risk; second, automated systems that are reliable, secure, and have adequate scalable capacity; third, emergency procedures, backup facilities, and a business continuity-disaster recovery plan; and fourth, regular, objective, independent testing to verify that the system safeguards program is sufficient to fulfill its regulatory responsibilities.

The entity must have a risk management program that addresses seven key elements, including information security, systems development, quality assurance, and governance. Clearinghouses, exchanges and these other institutions must also notify the Commission promptly of certain incidents and must have recovery procedures in place. Systemically important clearinghouses, for example, must be able to resume operations within 2 hours.

We conduct system safeguards examinations to determine compliance with these requirements, but we must remember the limitations of our oversight. Keep in mind that some of our major financial institutions are spending more on cybersecurity each year than our agency's entire budget. We do not engage in independent testing. Instead, we look at whether there is evidence to support management's assertions that they are in compliance with the requirements. Let me highlight some key areas that we focus on:

- Governance – Is the board paying sufficient attention to cybersecurity and taking appropriate steps? Does the board have the expertise, and does it devote the time, to do so? Is it setting the right tone as to the importance of these issues? The same questions apply, needless to say, to top management.
- Resources – Are sufficient resources and capabilities being devoted to monitor and control cyber-related risks across all levels of the organization?
- Policies and Procedures – Are adequate plans and policies in place to address information security, physical security, system operations, and other critical areas? And is the regulated entity actually following its plans and policies, and considering how plans and policies may need to be amended from time to time in light of technological, market or other security developments?
- Vigilance and Responsiveness to Identified Weaknesses and Problems –If a weakness or deficiency is identified, does the regulated entity take prompt and thorough action to address it? Does it not only fix the immediate problem, but also examine the root causes of the deficiency?

Enforcement and Compliance

Let me briefly note one final priority, which is enforcement and compliance. Robust enforcement and oversight are crucial to maintaining the integrity of our markets, as well as public confidence.

Dodd-Frank provided the Commission with a number of new statutory tools to combat manipulation and practices that can distort the markets, and we are using them. To give just one example, Congress gave us new authority to attack "spoofing," where a party enters a bid or offer with the intent to move the market price, but not to consummate a transaction. Last year, we brought a civil action against a firm for spoofing, one of the first such cases, and last month, the U.S. Attorney for Illinois indicted an individual from that firm for spoofing, based on a referral from us. We are equally focused on using our authority to ensure compliance with basic rules. Earlier this year, we imposed penalties against a major bank for failing to abide by our reporting requirements.

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

CFTC Resources

Let me conclude by saying that to do our job well, the CFTC must have sufficient resources.

And in my view, our current budget falls short.

I keep the Teddy Roosevelt adage in mind: we will do what we can, with what have, where we are. But our current budget limits our ability to fulfill our responsibilities in a way that most Americans would expect. Cybersecurity – which I discussed earlier – is but one example. Our current budget does not permit us to conduct as many examinations as we should. The simple fact is that, without additional resources, our markets cannot be as well supervised; customers cannot be as well protected; market transparency and efficiency cannot be as fully achieved.

Closing

The United States has the best financial markets in the world. They have been a significant engine of our economic growth and prosperity. Good regulation is necessary to keep them that way. I look forward to continuing to work with you toward that goal.

Thank you.

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