Remarks of Timothy G. Massad before the Coalition for Derivatives End-Users

February 26, 2015

Thank you for inviting me today, and I thank Governor Engler for that kind introduction. I am very pleased to be here today.

I am also pleased to have had the opportunity to meet with many of you individually and to hear your concerns. And since June, when two other commissioners and I took office, we have all been doing a lot of listening. Through individual meetings. Through our Commission open meetings. And through our advisory committee meetings. Today in fact, we have the first meeting of our Energy and Environmental Market Advisory Committee since we took office.

Those meetings, like the name of your organization, remind us of why we have derivatives markets in the first place. They enable end-users – businesses of all types – to hedge risk. In the six years since the financial crisis began, there's been a lot of talk about derivatives. For most Americans, the word is probably associated with a vague notion of bad behavior by big banks that got us into trouble. They may not immediately associate the word with a utility company hedging the cost of fuel. Or a manufacturer locking in prices for metal supplies. Or an exporter managing foreign currency risk. But as you well know, the core function of the derivatives markets is to enable businesses to hedge price, production and other types of risk they routinely face. And therefore anyone in my position has to ask himself, well, are we making the markets better for the businesses that need them? Are we making sure they operate with integrity and without fraud? Can businesses use them effectively and efficiently?

The global financial crisis, however, taught us that this is not the only thing we must think about. The crisis showed us how excessive risk in the over-the-counter derivatives market could contribute to systemic risk. The damage to our financial system and our economy from the global financial crisis is well known: eight million jobs lost, millions of homes foreclosed, many businesses shuttered, many retirements and college educations deferred. I spent five years working to help our nation recover from that crisis. And so as we seek to make sure these markets function well for the businesses that need them, we must at the same time make sure they do not create excessive risk to our financial system or our economy generally.

If you look at what we have been doing since June, you will see that we are addressing both those goals. It has been a busy and productive time. We have been active in a number of areas. We have been addressing the specific concerns of end-users in a number of areas. We have been continuing the work to bring the over-the-counter swaps market out of the shadows and implement the needed regulatory reforms mandated by Congress. We have also continued to carry out our traditional responsibilities of surveillance, compliance, and enforcement. And we have been addressing new developments and challenges in our markets, particularly those created by technological development.

The agency is fortunate to have a talented staff. The progress we have made is a credit to their hard work and dedication. My fellow commissioners each bring valuable experience and judgment. I commend my fellow commissioners in particular for their efforts to reach out and make sure we are all well informed by a diversity of views, and for their willingness to collaborate and work constructively together. I believe all of us are working in good faith to carry out the CFTC's responsibilities.

Today I want to review some of the things we have done over the last eight months, and discuss some of the things we will be doing in the upcoming months.

Making Sure the Markets Work for Commercial End-Users

Over the last 8 months, we have made it a priority to address concerns of commercial end-users. An important part of this effort has been fine-tuning our rules. This is, of course, a natural process for any regulatory agency, but it is particularly appropriate in our case. That is because the CFTC's responsibilities were increased dramatically as a result of the worst financial crisis this country has faced since the Great Depression. As you know, the agency was given the responsibility to implement a new regulatory framework for the over-the-counter swaps market, a $400 trillion market in the U.S., measured by notional amount.

To fulfill that responsibility, the CFTC developed and published many new rules. With reforms as significant as these, it is inevitable that there will be a need for some adjustments. And that is what we have been doing.

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

In November, the Commission proposed to modify one of our customer-protection related rules to address a concern of many in the agricultural community and many smaller customers regarding the posting of collateral. These rules had been unanimously adopted in the wake of MF Global's insolvency and were designed to reduce the risk of similar failures and to protect customers in the event of such a failure. Market participants asked that we modify one aspect of the rules regarding the deadline for futures commission merchants to post "residual interest," which, in turn, can affect when customers must post collateral. I expect that we will finalize this rule change in the near future.

We have taken a number of other steps as well. We have proposed to clarify when forward contracts with embedded volumetric optionality – a contractual right to receive more or less of a commodity at the negotiated contract price – will be excluded from being considered swaps so that commercial companies can continue to conduct their daily operations efficiently. We have proposed to revise certain recordkeeping requirements to lessen the burden on commercial end-users and commodity trading advisors. The Commission staff has taken action to make sure that end-users can use the Congressional exemption given to them regarding clearing and swap trading if they enter into swaps through a treasury affiliate.

CFTC staff also recently granted relief from the real-time reporting requirements for certain less liquid, long-dated swap contracts, recognizing that immediate reporting can undermine a company's ability to hedge.

In sum, we have been very focused on fine-tuning the rules to make sure they work for commercial end-users, and we will continue to do so. For example, I know several of your companies are working on submitting Form TO to report trade option positions before the March 1st deadline. I've asked the CFTC staff to look at the usefulness of this information and we will consider changes to reduce the reporting currently required for trade options.

Implementing the New Swap Framework

Congress recognized the importance of addressing the needs of commercial end-users in creating a regulatory framework for the over-the-counter swaps market. In the Dodd-Frank Act, Congress specifically exempted commercial end-users from the requirement to trade swaps on regulated exchanges and the requirement to clear swap transactions through central counterparties. Congress recognized that the activities of commercial end-users in the derivatives markets do not create the same types or degree of risk as with large financial institutions, and so Congress provided these exemptions to minimize the potential cost impacts of necessary regulatory reform on commercial end-users. And last December, Congress took further action to make it clear that end-users are to be exempted from the requirement to post margin in connection with swaps that are not cleared.

Now, the actions we are taking with respect to the proposed rule on margin for uncleared swaps reflect this Congressional direction. Indeed, the proposed rule on margin for uncleared swaps reflects three of the most important priorities facing the Commission: first, this rule is one of the most important steps we need to take to finish the work of bringing the swaps market out of the shadows and addressing the potential for excessive risks coming out of that market; second, we are implementing this rule in a way that addresses the needs of end-users to make sure they can continue to use the derivatives markets effectively; and third, we are trying to harmonize our proposed rule as much as possible with the rules on margin for uncleared swaps of other jurisdictions. So let me take a few minutes to discuss where we are with the proposed rule on margin for uncleared swaps.

First, this rule is important because uncleared transactions will continue to be an important part of the swaps market. It was critical that we mandated clearing of standardized swaps at centralized counterparties, and we have made great progress in implementing that mandate. But not all transactions will or should be cleared. Sometimes, commercial risks cannot be hedged sufficiently through swap contracts that are available for clearing. Certain products may lack sufficient liquidity to be centrally risk managed and cleared. This may be true even for products that have been in existence for some time. And there will and always should be innovation in the market, which will lead to new products that lack liquidity.

That is why the rule on margin for uncleared swaps is important. 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.

The second issue is the end-user concern. The rule we proposed last September on margin for uncleared swaps exempted commercial end-users from the requirement to post margin. This was also true of the original rule we proposed in 2011. Most recently, we worked with the bank regulators, who must also write margin rules, so as to harmonize our rules with theirs as much as possible, and I am pleased that their latest rules also exempt end-users. And in light of the passage of the margin provisions in the TRIA bill, we are working to implement these statutory end-user margin protections quickly through an interim final rule, as Congress intended.

In addition to harmonizing with the U.S. bank regulators, I also think it is very important that our rules be as similar as possible with the rules that Europe and Japan are looking to adopt. For that reason, we have spent considerable time in discussions with our international counterparts. In this regard, I am willing to consider some changes to our proposed rule in order to ensure greater consistency. For example, the threshold for when margin is required is currently lower in our proposed rule than in the proposals in Europe and Japan, and I believe we should harmonize those even if it means increasing ours. I would expect us to finalize a rule by the summer, and I expect that we will incorporate a slight delay in the implementation timetable for the rule.

With regard to cleared transactions, we have made significant progress and continue to move forward. Today, the percentage of transactions that are centrally cleared in the markets we oversee is about 75 percent, up from about 15 percent at the end of 2007. Clearing through central counterparties is now required for most interest rate and credit default swaps. As directed by Congress, our rules specifically exempt commercial end-users. Clearing mandates are also coming on line in other jurisdictions.

Of course, clearing does not eliminate the risk that a counterparty to a trade will default. Instead, it provides us with strong tools to manage that risk, and mitigate adverse effects should a default occur. For central clearing to work well, active, ongoing oversight is critical. So we are very focused on ongoing surveillance of clearing member risk. We are focused on examinations of clearinghouses, so that we make sure clearinghouses have the financial, operational and managerial resources, and all the necessary systems and safeguards, to operate in a fair, transparent, and efficient manner. We must also make sure that

contingency plans for clearinghouse recovery are sufficient, and we will be holding a roundtable in early March to discuss these issues. I am looking forward to gathering feedback from a variety of market participants, including commercial end-users.

We are also continuing to work with the European Commission on cross-border recognition of clearinghouses.

We are also working on two other rules regarding capital and position limits. Congress mandated that we implement position limits to address the risk of excessive speculation. In doing so, we must make sure that commercial end-users can continue to engage in bona fide hedging. We have received substantial public input on the position limits rule. It is important that we consider these comments carefully. Commission staff is also considering next steps on the rule for capital for swap dealers, which is another rule where we are working together with other regulators. As with the rule on margin for uncleared swaps, we will take the time necessary to get these rules right.

New Challenges and Risks

We are also doing all we can to address new challenges and risks in our markets, which can directly impact participants, including commercial end-users. We have been very focused on the increased use of automated trading strategies, for example, and their impact on the derivatives markets.

Cybersecurity is perhaps the single most important new risk to market integrity and financial stability. The risk is apparent. The examples from within and outside the financial sector are all too frequent and familiar: Anthem, JP Morgan, Sony, Home Depot, and Target among others. Some of our nation's exchanges have also been targeted or suffered technological problems that caused outages or serious concerns. And because of the interconnectedness of financial institutions and market participants, an attack at one institution can have significant repercussions throughout the system.

Because critical parts of the plumbing of the financial system are under our jurisdiction, there is no question that cybersecurity must be a priority for us. The question is how can we be most effective in this area? After all, many financial institutions are spending more on cybersecurity than our entire budget. One bank recently told me they had a cyber operations budget, and a cyber change budget, and each was a multiple of our budget. There were news reports recently that one financial institution is hiring 1,000 people dedicated to digital security. We have about 2/3 of that number in total. And there are many government agencies who have built up great expertise on cybersecurity.

So we are addressing it in the following ways: first, cyber concerns are now part of the core principles that trading platforms and clearinghouses must meet. Second, we have required these entities to develop and maintain risk management programs and recovery procedures that meet certain standards. Third, we are focusing on these issues in our examinations. We are looking at whether the institution is following best practices. Is the board of directors focused on the issue? Is there a culture in which cybersecurity is given priority? Has the entity not only adopted good policies on cybersecurity, but are those policies being observed and enforced?

Another issue we will focus on is whether the private companies that run the core infrastructure under our jurisdiction –the major exchanges and clearinghouses for example – are doing adequate testing themselves of their cyber protections. We do not have the resources to do independent testing, but they do. So are they doing it? And what are the best practices they should follow in doing testing? We intend to hold a roundtable on this issue next month.

Resources

While we have made substantial progress over the last 8 months, there is much more we should be doing. Not only do we now have responsibility for the swaps market, but our traditional markets have grown in size and complexity. To do so we must have resources that are proportionate to our responsibilities, and we must use them wisely.

In my view, the CFTC's current budget still falls short. We cannot be as responsive to your concerns as we wish to be. We cannot do as much to prevent fraud and manipulation, and to engage in the surveillance that helps insure our markets operate with integrity. Simply stated, without additional resources, our markets cannot be as well supervised; participants and their customers cannot be as well protected; market transparency and efficiency cannot be as fully achieved.

Conclusion

The United States has the best derivatives markets in the world – the most dynamic, innovative, competitive and transparent. They have been an engine of our economic growth and prosperity, in large part because they have attracted participants and served the needs of commercial end-users who depend on them. I look forward to working with all of you to make sure that they continue to do so in the years ahead.

Thank you for inviting me. I would be happy to take some questions.

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