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

SPEECHES & TESTIMONY

Opening Statement of Commissioner J. Christopher Giancarlo, Open Meeting on Proposed Rule on Residual Interest Deadline for Futures Commission Merchants, Proposed Rule on Records of Commodity Interest and Related Cash or Forward Transactions, and Proposed Interpretation on Forward Contracts with Embedded Volumetric Optionality

November 3, 2014

Mr. Chairman, thank you for calling this meeting to propose three important matters. I am pleased the issues that the three proposals seek to address are being made a priority by this iteration of the Commission. These measures are of tremendous consequence to farmers, manufacturers, and utilities, and the markets that serve them. We must get them right.

Proposed Rule on Residual Interest Deadline for Futures Commission Merchants

I support the issuance of the proposed rule before us on the residual interest deadline for futures commission merchants (FCMs). Without it, the so-called and, perhaps, misnamed "customer protection" rule finalized in October 2013 would likely result 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.

As it stands, the rule will cause farmers and ranchers 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. Without revision, the increased costs of pre-funding accounts will likely drive many small and medium-sized agricultural producers out of the marketplace. It would likely force a further reduction in the already strained FCM community that serves the agricultural community.

Last week, I visited a grain elevator in southern Indiana and a family farm in rural Kentucky. 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 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.

But today there is good news. After a significant amount of public comment, and two identical and bipartisan pieces of legislation in both the House and the Senate, today's proposed rule revision would amend Commission regulation 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. This change will be well received by the farmers I spoke to last week.

I commend the Commission for today's action. I am also satisfied that concerns of my staff were addressed so that any change to this deadline only take place after a rulemaking following a public comment period. As noted in the proposal, this approach will allow the Commission to better understand the market impacts and operational challenges before moving the residual interest deadline. This approach is especially important given the potential impact on smaller Futures Commission Merchants and end-users.

While on the subject of automatic adjustments, I call on the Commission to take the same deliberative approach in other areas where there are automatic adjustments to Commission rules. Specifically, the Commission should revisit the *de minimis* exception to the swap dealer definition and revise this definition so that the *de minimis* level does not automatically adjust from $8 billion to $3 billion, absent a rulemaking with proper notice and comment. Like today's proposal, the Commission should only adjust the *de minimis* threshold after it has considered the data and weighed public comments.

As for today's rule on Residual Interest, I am pleased to support it.

Proposed Rule on Records of Commodity Interest and Related Cash or Forward Transactions

In 2012, the CFTC revised Rule 1.35. The changes require the keeping 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." This record keeping must be done (with certain carve outs) by most futures commission merchants (FCMs), retail foreign exchange dealers, introducing brokers, and members of designated contract markets and swap execution facilities.

As with the Seven-Factor Volumetric Optionality Test (that we are also discussing today), the revised Rule 1.35 has proven to be simply unworkable. Publication of the Rule was followed by requests for no-action relief. At a Public Roundtable held in this room, market participants 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 had little utility. 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."

The revisions to Rule 1.35 that the Commission is proposing today go a long way towards addressing the Rule's difficulties. Unfortunately, they do not go far enough. The proposed Rule text raises unanswered questions. It continues to contain provisions that may be difficult or overly burdensome in practice for certain covered entities. In my opinion, many of the problems stem from imprecise construction and definition in the legal drafting.

Allow me to dig down into the weeds for a while to be specific about my concerns: Section (a)(1) of the proposed Rule identifies the records that must be kept by entities subject to the rule, which include "all pertinent data and memoranda of all transactions relating to its business of dealing in commodity interests and related cash or forward transactions, including all orders, trading cards, signature cards, street books, journals, ledgers, canceled checks, copies of confirmations, copies of statements of purchase and sale, and all other records prepared in the course of its business of dealing in commodity interests and related cash or forward transactions." Section (a)(2) of the proposal requires that all such records shall be "searchable," and "kept in a form and manner that allows for identification of a particular transaction, except that oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a transaction need not be identifiable by transaction."

Section (a)(6) of the proposed Rule requires covered entities to retain Rule 1.35 records in accordance with Rule 1.31. Rule 1.31 (which applies to all books and records required to be kept by the CEA and Commission regulations), contains detailed requirements regarding the form and manner in which such records must be maintained and produced. It states, among other things, that paper records shall be kept in their original form, and that electronic records shall be kept in their native file format. It also requires that records be produced "in a form specified by any representative of the Commission." Thus, Rule 1.35 identifies the particular records that must be kept, while Rule 1.31 sets the form and manner in which such records must be maintained and produced. But the proposal adds new requirements regarding form and manner – that the records allow for identification of a particular transaction and be "searchable," a term that is not defined.

While it is likely that electronic records kept in their native file format can easily be produced in a searchable form, it is not clear what "searchable" means when it comes to paper records such as canceled checks, signed account agreements, and paper orders. Does this mean that a record of a wire transfer received by an FCM to cover margin for multiple positions be kept in a form and manner that allows for identification of each potential transaction? Will a small FCM embedded in a grain elevator have to keep the cancelled checks received from farmers in some sort of searchable format tied to specific transactions? What if the farmer's check mistakenly references the wrong transactions and the FCM doesn't catch it? Is the FCM now in breach of our rules? Do they need to hire a whole paper records "searchability" team just to tie records to individual transactions in the event, but not the certainty, that someday the CFTC will want those records? At what cost to them and to American markets and end-users?

Alright, let me come up from the weeds and look at the forest from the trees. FCMs are vital to the functioning of America's commodity futures markets. They are essential intermediaries between farmers, manufacturers and other end-users, and the markets in which they hedge the risks and costs of production. Without healthy FCMs serving their customers, the everyday costs of groceries and winter heating fuel will rise for American families. Yet, today we have around half the number of FCMs serving our farmers than we did a few years ago. FCMs, particularly small FCMs, are being squeezed by the current environment of low interest rates and increased regulatory burdens. They are barely breaking even. We should not be squeezing them further with increased compliance costs if we can avoid it and still effectively oversee the markets. In implementing the Dodd Frank

Act, I am conscious that the stated purpose, and indeed its official title purports to reform "Wall Street." Instead, we are harming "Main Street" by forcing burdensome new compliance costs onto our country grain elevators, farmers, and small FCMs.

Rather than facilitating the collection of useful records to use in investigations and enforcement actions, the underlying rule and the lack of sufficient relief provided in today's proposal will instead result in senseless cost increases. Increased costs may even curtail the use of sound risk management tools needed to help farmers hedge the risks - and there are many - of growing the crops that feed and fuel our nation.

The one refrain I heard again and again last week in Illinois, Indiana and Kentucky was that Washington does not listen to ordinary American farmers, energy producers, coal miners and manufacturers. They say that Washington imposes rules and regulations without regard to their everyday impact on ordinary people. Well, here we have a chance to listen and act accordingly.

I encourage all affected parties to give us detailed comments on the proposal, with emphasis on the intersection between Rule 1.35 and Rule 1.31, and how the proposed searchability and identification by transaction requirements will work in practice. I encourage the public to make us listen once again to their concerns about costs and benefits of this particular rule set. While I do not support today's proposal, I am hopeful that after thoughtful consideration of the comments to this proposal the Commission will promulgate a final rule that better balances the legitimate demands of market regulation with undue burdens on American agriculture and manufacturing.

Proposed Interpretation on Forward Contracts With Embedded Volumetric Optionality

Risk management contracts that allow for an adjustment of the quantity of a delivered commodity 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. These contracts – known as "Forward Contracts with Embedded Volumetric Optionality" or EVO Forwards – are widely used in everyday business and do not pose a threat to the stability of financial markets. They should not be regulated the same as financial derivatives.

EVO Forwards are expressly exempted from the definition of a "swap" under the Commodity Exchange Act. Yet, the CFTC's guidance on how to apply the definition using a "Seven-Factor Test" has been burdensome, unnecessary and duplicative. The Commission captured a large swath of transactions that are not and should not be regulated as "swaps," including EVO Forwards.

The regulation of these transactions will actually 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 costly and unnecessary regulation thwarts the intent of Congress under the Dodd-Frank Act.

Recently, I was able to see firsthand how important EVO forwards are to the utilities marketplace to ensure a stable and affordable supply of electricity. I visited a Kentucky aluminum smelter, whose massive operations use the same amount of electricity as the City of Louisville on a daily basis. In times of stress to the electricity grid, such as during a polar vortex or during intense summer heat, EVO forwards help utilities ensure that this plant's 24 hour a day operations do not cease. The aluminum from this smelter makes its way into everything from beer cans and automobiles to the production of U.S. fighter aircraft currently protecting our freedom around the globe. Without the use of EVO forwards, this Kentucky smelter would incur increased production costs compared to its overseas competitors in Saudi Arabia, China and Brazil.

Our American economy is simply too complex and interconnected to turn a blind eye to the impact of our actions in Washington. We cannot afford to make it harder or more costly for our manufacturers and utilities to manage risks of supply. Increased costs to our American manufacturing bases represent an economic, and in this case, strategic and national security risk, to our country.

Today's proposed interpretation of the seventh prong of the seven-factor test benefits from thoughtful review by my fellow commissioners. It provides a good start to providing some sensible relief from the problems arising from the seven-prong test. Although a change to the underlying product definition would be strongly preferred, today's proposal, at least in the short term, hopefully will provide relief through a revision to the CFTC's interpretation of the rules. Although there have been reams of paper used to comment on the product definition and the seven-factor test, I ask that market participants submit their comments,

concerns, and suggestions once again to help guide the Commission to provide certainty to a vital marketplace.

Conclusion

I want to close by thanking staff for their hard work on these three proposals. I look forward to reviewing thoughtful comments.

Last Updated: November 3, 2014