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

SPEECHES & TESTIMONY

Opening Statement of Timothy G. Massad, Commission Open Meeting

November 3, 2014

Today we are considering three matters that all involve fine tuning our rules to make sure they work as intended. These are all adjustments to previously issued rules, and they are appropriate to make sure our rules do not impose undue burdens or unintended consequences, particularly for the nonfinancial commercial businesses that use these markets to hedge commercial risks. This is 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. We were given the responsibility to oversee the over-the-counter derivatives market, a $700 trillion market that was largely unregulated prior to the crisis. As we know, excessive risks related to this market were one of the causes of the crisis. The CFTC developed and published many new rules to implement that responsibility and it updated certain other related rules in the course of doing so.

With reforms as significant as these, it is inevitable that there will be a need for some minor adjustments. And that is what we are doing. The changes we are proposing today help insure that as we regulate the potential for excessive risks in these markets, we make sure that the commercial businesses—whether they are farmers, ranchers, manufacturers or others—that rely on these markets to hedge routine risks can continue to do so efficiently and effectively.

The first item we are considering is a proposed amendment to Regulation 1.22. This rule helps insure that the funds deposited by customers with Futures Commission Merchants, or FCMs, remain safe. The rule prohibits an FCM from using customer funds of one customer for the benefit of another customer. Last fall, the Commission amended Regulation 1.22 to further enhance the safety of such funds by making sure that customer accounts have sufficient margin. On any day when a customer is required to post additional margin but has not yet done so, the FCM must maintain its own capital – often referred to as the FCM's "Residual Interest" – in customer segregated accounts to make up the difference. The amendments provided that the FCM must deposit the additional funds by a specified deadline. Specifically, the amendments said that as of November 14, 2014, the deadline would be 6:00 pm Eastern Time on the settlement date.

Now of course, the deadline for the FCMs to post their capital affects the deadline for customers to increase their own funds. The amendments passed last fall also provide that the Commission will conduct a study, and solicit public comment—including by way of a public roundtable-- concerning the practicability, for both FCMs and their customers, of moving that deadline from 6:00 pm to the morning daily clearing settlement cycle or the time of settlement, which I will refer to as 9am for convenience. The amendments said the Commission would decide, within nine months after publication of the report, whether to move the deadline to 9:00 am. Finally, the amendments said that if the Commission failed to take any action, the deadline would automatically move to 9:00 am as of December 31, 2018.

Today, we are making a minor, but important, change. We are proposing to eliminate the provision that says the deadline will automatically move to 9:00 am as of December 31, 2018. The deadline will still move to 6:00 pm as of November 14 of this year, and we will still conduct a study of the practicability of making the deadline earlier. An earlier residual interest deadline better protects customers from one another, in line with the statute, but we want to make sure we move deliberately so that the model works best for customers in light of all of their interests, since the deadline will affect how much margin customers have to post and when. Today's proposal will make sure that customers have an opportunity to not only review the study but give us input when we consider whether to accelerate the deadline.

The second item today consists of proposed amendments to Regulation 1.35. This regulation requires various types of market participants to keep written and oral records of transactions. This record keeping is very important to our efforts to police the markets and insure integrity and transparency.

Regulation 1.35 has been on the books since 1948, and we have updated it from time to time in light of changes in marketplace practices as well as the scope of our jurisdiction. After the Commission amended this rule in December 2012 and the Staff observed implementation of these changes, the Staff determined that the costs of complying with certain aspects of the rule for some market participants might exceed the potential benefits, and the Staff granted no action relief. Specifically, the Staff said that regarding written records, members of DCMs and SEFs that are not registered with the Commission do not have to keep text messages or store their other records in a manner that is identifiable and searchable by transaction. Regarding oral communications, Staff said that commodity trading advisors do not have to record oral communications regarding their swap transactions. The costs of maintaining the records that our rules require market participants to keep will ultimately be reflected in the transaction costs incurred by all customers, and so we must always keep the costs in balance with the benefit to market oversight. Today, we are simply proposing to revise the rule so that it reads consistent with that staff no action relief and to provide a slight expansion of some of that relief so that CTAs do not have to record any oral communications. We are also proposing to clarify one aspect of the rule that has generated confusion. This pertains to the requirement that records must be identifiable and searchable by transaction and what “identifiable and searchable” means.

The third matter item we are considering pertains to forward contracts that have what is known as embedded volumetric optionality—generally speaking, contracts to buy or sell a nonfinancial commodity for deferred delivery that provide for variations in delivery amount. In certain situations, commercial parties are unable to predict at the time a contract is entered into the exact quantities of the commodity that they may need or be able to supply, and the embedded volumetric optionality offers them the flexibility to vary the quantities delivered accordingly. The CFTC put out an interpretation, consisting of seven factors, to provide clarity as to when such contracts would fall within the forward contract exclusion from the swap definition, but some market participants have felt this interpretation, in particular the seventh factor, was hard to apply. In some cases, the two parties would reach different conclusions about the same contract.

Today we are proposing clarifications to the interpretation that I believe will alleviate this ambiguity and allow contracts with volumetric optionality that truly are intended to address uncertainty with respect to the parties’ future production capacity or delivery needs, and not for speculative purposes or as a means to obtain one-way price protection, to fall within the exclusion. I note also that, because this proposed interpretation pertains to the definition of a swap, we are coordinating with the SEC on this.

With respect to all three proposals today, if adopted, there will be an opportunity for public comment before we take any final action.

Last Updated: November 3, 2014