THE FUTURE OF THE CFTC: COMMISSION PERSPECTIVES

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

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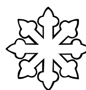

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CONTENTS

Page

Conaway, Hon. K. Michael, a Representative in Congress from Texas, opening statement 1
  Prepared statement 2
Scott, Hon. David, a Representative in Congress from Georgia, opening statement 3

WITNESSES

O'Malia, Hon. Scott D., Commissioner, U.S. Commodity Futures Trading Commission, Washington, D.C. 4
  Prepared statement 6
  Submitted questions 51
Wetjen, Hon. Mark P., Commissioner, U.S. Commodity Futures Trading Commission, Washington, D.C. 20
  Prepared statement 22
  Submitted questions 62

THE FUTURE OF THE CFTC: COMMISSION PERSPECTIVES

TUESDAY, JULY 23, 2013

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:01 a.m., in Room 1300 of the Longworth House Office Building, Hon. K. Michael Conaway [Chairman of the Subcommittee] presiding.

Members present: Representatives Conaway, Neugebauer, Austin Scott of Georgia, Hartzler, Noem, LaMalfa, Hudson, Collins, Lucas (*ex officio*), David Scott of Georgia, Vela, Gallego, Vargas, Maloney, Walz, Negrete McLeod, and Costa.

Staff present: Debbie Smith, Jason Goggins, Josh Mathis, Suzanne Watson, Tamara Hinton, Caleb Crosswhite, John Konya, C. Clark Ogilvie, Liz Friedlander, and Riley Pagett.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

The CHAIRMAN. All right. It is 10 o'clock. We are going to go ahead and start. This hearing of the Subcommittee on General Farm Commodities and Risk Management entitled, *The Future of the CFTC: Commission Perspectives,* will come to order.

Good morning. I would like to welcome all of you to the second in a series of Agriculture Committee hearings on the future of the CFTC. Today's hearing builds on the perspectives shared at the full Committee hearing in May.

I am pleased to welcome Commissioners Scott O'Malia and Mark Wetjen to share their perspectives on what works at the Commission and what doesn't, assuming there is anything that doesn't work over there. But thank you both for being with us this morning. I look forward to your perspectives.

About 5 years ago, American's watched in horror as the financial services industry imploded, draining trillions of dollars from their investment portfolios and retirement plans. In response, Congress passed the Dodd-Frank Act requiring financial regulators to look deeper into the markets that they oversee. In many ways, Dodd-Frank fundamentally changed the regulators as much as it sought to remake the financial markets themselves.

Congress mandated a staggering amount of work for the CFTC to get done, and it has transformed the Commission, conferring vast new registration, reporting and oversight powers to it. The

Commission has spent the past 3 years on this Herculean task, but today, it is still frustratingly behind schedule on some of those. Rulemakings that were supposed to be completed in a year have slipped into the third year.

But perhaps more concerning has been the pattern of 11th-hour delays of unworkable rules or guidance. The confusion and delay stemming from the Commission's actions are adding up to real costs for market participants. Many companies are in limbo, unsure of how to plan for the impact of the rules that might change.

Every hearing, I remark that getting Dodd-Frank done correctly is more important than getting it done quickly, but the Commission seems to be failing at both, unable to complete its work correctly or expeditiously. A good example of a rule that I am concerned about and one that we will get into further in the weeks to come is the customer protection rule that the Commission has recently proposed.

The proposed rule requires futures commission merchants to hold additional margin and capital to cover all potential shortfalls by customers. This proposal would be expensive to implement and could harm the very customers it seeks to help by raising costs and reducing market competition. Proposed last November, this rule is not ready and has caused needless concern amongst smaller market participants who would bear the greatest burdens in complying with this rule.

The Commission must do a better job seeking and considering objective data at the front end of rulemaking, which is why Ranking Member Scott and I have introduced legislation to require the CFTC to conduct an actual analysis of costs and benefits when it proposes new rules. I hope that Commissioners O'Malia and Wetjen can testify about additional ways they believe the internal processes and culture at the Commission can be improved. I look forward to a fruitful discussion on how to make sure the rulemaking process at the CFTC is coherent and transparent and how to ensure the Commission's future actions are timelier and better prepared.

Finally, as we look at options for how to improve the CFTC, we cannot forget to look closely at Congressional mandates for reports, actions, offices, and other requirements on the Commission that may be outdated or redundant because of newer requirements. I firmly believe that repealing outdated sections of law is just as important as implementing new ones.

With that, I would like to again thank both Commissioners O'Malia and Wetjen. It is critical that the Committee have your perspectives on what is working at the Commission and what is not. Your time appearing today and the time you spent preparing over the past several weeks is much appreciated by David and myself.

[The prepared statement of Mr. Conaway follows:]

PREPARED STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Good morning. I'd like to welcome you all to the second in a series of Agriculture Committee hearings on the future of the CFTC. Today's hearing builds on the perspectives shared at the full Committee hearing in May.

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In many ways, Dodd-Frank fundamentally changed the regulators as much as it sought to remake the financial markets. Congress mandated a staggering amount of work for the CFTC and it has transformed the Commission, conferring vast new registration, reporting, and oversight powers to it.

The Commission has spent the past 3 years on this Herculean task, but today, it is frustratingly behind schedule. Rulemakings that were supposed to be completed in a year have slipped into their third year. But, perhaps more concerning has been the pattern of eleventh hour delays of unworkable rules or guidance.

The confusion and delay stemming from the Commission's actions are adding up to real costs for market participants. Many companies are in limbo, unsure of how to plan for the impact of rules that might still change. Every hearing, I remark that getting Dodd-Frank done right is more important than getting it done quickly, but the Commission seems to be failing at both, unable to complete its work correctly or expeditiously.

A good example of a rule that I am concerned about, and one that we will get into further in the weeks to come, is the customer protection rule the Commission has proposed. The proposed rule would require futures commission merchants to hold additional margin and capital to cover all potential shortfalls by customers. This proposal would be expensive to implement and could harm the very customers it seeks to help by raising costs and reducing market competition. Proposed last November, this rule is not ready and has caused needless concern among smaller market participants who would bear the greatest burdens in complying.

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I'd like to now turn to my able partner on this Subcommittee, Ranking Member Scott, for his opening remarks.

The CHAIRMAN. I would now like to turn to my able partner on the Subcommittee, Ranking Member David Scott, for his opening remarks.

OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you very much, Mr. Chairman, and certainly to you, Mr. Wetjen and Mr. O'Malia. We certainly appreciate your coming here.

Today's hearing is an especially important one but it is not only important just to hear about the workings of the CFTC but about you as an agency, about your budget, about your appropriations, about your needs. Your last appropriations was 5 years ago. So much has been thrown at you over the last 5 years. We have had the financial crisis, meltdown of Wall Street. We have had to come

up with answers to that, and we have had the birth and the implementation 3 years ago of Dodd-Frank. You have had to come up with that. We have had an ever-growing derivatives market now that is valued at $637 trillion, a piece of the world economy. You have had to have rules for that.

So you have had a lot thrown at you. You have done a very good job. And it is important, Mr. Chairman, that as we look at this 3 year anniversary of Dodd-Frank, it is important to note that the CFTC has gone from what was once sort of an obscure parochial regulatory body to now one of the most powerful governmental agencies in the world. And the task that we in Congress gave them was not an easy one, but they have done so and have done an extraordinary job and yeoman's work. And not just this Commission but their staff. I know, and it has to be, that the workload of this staff has probably quadrupled what we have had.

So it is very important that we hear from you to make sure that you, as your budget is about to expire in the next 9 weeks or so, that we hear from you to know exactly what your needs are because we, this Subcommittee, certainly wants to make sure that you have the funding that you have needed, the technology that you have needed. We can sit here and make these laws of cross-border and push out and having all of these derivatives, but we have to depend upon you to tell us, "Congress, you want us to do this job, you want us to do it right. Here is what we need to do it and here is why." I think that is very important to get across in this hearing today.

So, Mr. Chairman, with that I will yield back the balance of my time.

The CHAIRMAN. Thank you, David. I appreciate that. It is my honor to welcome the panel of witnesses to the table today. We have Mr. Scott O'Malia, Commissioner, U.S. Commodity Futures Trading Commission, Washington, D.C.; and the Honorable Mark Wetjen, Commissioner, U.S. Commodity Futures Trading Commission out of Washington, D.C. So, Mr. O'Malia, we have both of your written statements for the record but please visit with us about the things that you think are the most important out of your written testimony, sir. With that, Scott, you have the floor.

STATEMENT OF HON. SCOTT D. O'MALIA, COMMISSIONER, U.S. COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. O'MALIA. Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee, I am pleased to be invited here today to discuss the CFTC's implementation of Dodd-Frank. I am also pleased to be able to participate in this hearing and joined by my fellow Commissioner and colleague, Commissioner Mark Wetjen.

In summarizing my testimony, I will focus on three main topics. First, I would like to discuss the challenges that end-users face as a result of the Commission's approach to the implementation of Dodd-Frank. Second, I will discuss the serious concerns I have with the Commission's rulemaking process. And finally, I will discuss the challenges in the Commission's data utilization efforts and the

importance of technology in meeting the Commission's expanded mission.

Even a brief review of the legislative history of the Dodd-Frank Act demonstrated that it was Congress' intent to protect commercial end-users from Dodd-Frank's expansive regulatory reach. The swap dealer rule is a good example of the Commission's failure to accurately interpret Dodd-Frank. The rules make it unnecessarily difficult to determine whether an entity is a swap dealer or an end-user. It broadly applies the *swap dealer* definition to all market participants and ignores the statutory mandate to exclude end-users.

Rather than providing a bright-line test or expressly excluding end-users, the swap dealer rule lists numerous factors that should be considered in determining whether an end-user's commercial activity might be swap dealing. As a result, end-users have shied away from the ambiguous facts and circumstances test and instead have relied on provisions that excuse a dealer from registration with the Commission if its aggregate dealing activity is below an $8 billion *de minimis* threshold, which is an arbitrary amount that is not based on data. I would encourage Congress to exclude end-users from the *swap dealer* definition. In the alternative, Congress should also consider allowing commercial entities not to count their cleared swaps as part of their $8 billion *de minimis* calculation.

Another area that deserves Congressional attention is customer protection in bankruptcy. The importance of these issues is emphasized by the recent cases involving the blatant misuse of customer funds by FCMs. In 2010, MF Global misappropriated over $900 million to cover its own proprietary losses. One year later, Peregrine Financial and its founder Russell Wassendorf stole over $200 million in customer funds. Both the industry and the Commission have taken steps to increase the level of protections to prevent something like this from happening again. It is inexcusable that these FCMs failed to protect customer funds. Although these violations were not because of a lack of regulation, I believe there is room for improvement.

As I explain in more detail in my written testimony, I believe that Congress should consider improving customer protections in bankruptcy. First, I believe customers will benefit from increased CFTC authority in insolvency proceedings by appointing a CFTC trustee to look out for futures and swaps customers.

Second, Congress must ensure that customers are always first in line in any distribution of assets of an estate in bankruptcy.

Third, the Congress should revisit the *pro-rata* distribution rules, including creating the possibility of third-party segregation accounts that will not be comingled in bankruptcy.

Another area that needs improvement is the Commission's own rulemaking procedures. I think that everyone would agree that it is virtually impossible to achieve good policy outcomes without establishing sound processes for reaching these outcomes. The CFTC staff has issued an unprecedented number of no-action letters. So far, the staff has issued over 100 letters, including 24 letters that provide indefinite relief from hastily drafted rules. No-action letters are not voted on by the Commission. They are not published in the

Federal Register and do not include notice-and-comment periods. Thus, no-action letters should be used on a very limited basis.

I have always advocated that all Commission rulemaking must include a thorough cost-benefit analysis, both qualitative and quantitative, to ensure that our rules do not impose unreasonable costs. However, the cost-benefit provisions in the CEA do not currently require quantitative analysis. Thus, I am pleased that the House has passed the cost-benefit reform bill requiring the Commission to conduct quantitative analysis to justify the cost of its rules relative to their benefits.

In considering the Commission's reauthorization, it is entirely appropriate for Congress to review the Commission's internal procedures for compliance with the APA and insist on reforms to the Commission's cost-benefit analysis. It is also imperative for the Commission to better utilize technology given the Commission's expanded oversight responsibilities.

Since the beginning of 2013, certain market participants have been required to report their data to an SDR. Unfortunately, the Commission has struggled with analyzing this information. Earlier this spring, our surveillance staff admitted that they could not spot the London Whale trades in the current CFTC data. Solving our data dilemma must be the Commission's top priority. As the Chairman of the Commission's Technology Advisory Committee, I have formed a working group comprised of CFTC staff and various market participants, including the SDRs, to resolve this problem as soon as possible.

The Commission has been given the momentous task of creating a regulatory environment that increases transparency and improves stability in our financial markets. Therefore, the Commission must faithfully implement the statute in a consistent, clear, and cost-effective manner. This Committee has every right and responsibility to make the necessary and immediate changes it deems fit. I am happy to continue to work with this Committee to ensure that the Commission is operating as authorized and mandated under the CEA.

I am happy to answer any questions you have following our testimony. Thank you.

[The prepared statement of Mr. O'Malia follows:]

PREPARED STATEMENT OF HON. SCOTT D. O'MALIA, COMMISSIONER, U.S. COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee, I am pleased to be invited here today to discuss the Commodity Futures Trading Commission ("CFTC" or "Commission")'s implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"),[1] as well as the Commission's oversight of the derivatives markets.

I'd like to first recognize the tremendous efforts by CFTC staff to implement the sweeping reforms of the Dodd-Frank Act, including the Commission's new authority to oversee the over $600 trillion swaps market. They have put in many hours of hard work over the past 3 years to carry out the CFTC's mission, and should be commended for their achievements.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

The Dodd-Frank Act was enacted to implement the four principles agreed to by the G20 nations who finalized the Pittsburgh Communiqué on September 25, 2009.[2] These four principles are (1) reporting of all trades to a trade repository, (2) requiring that "all standardized OTC derivatives should be traded on exchanges or electronic trading platform, where appropriate," (3) "clearing through central counterparties," and (4) higher collateral charges for all uncleared over-the-counter ("OTC") derivatives contracts.

The CFTC was charged with the mandate to reduce risk, increase transparency, and promote market integrity under the reforms set forth in Title VII of the Dodd-Frank Act. Unfortunately, the Commission's implementation of Dodd-Frank has made it difficult for commercial end-users to comply with CFTC regulations and made hedging more complicated and expensive.

My testimony today will focus on three main topics. First, I will discuss challenges presented by the Commission's policy approach to the implementation of Dodd-Frank and its negative impact on commercial end-users. I will include suggestions to improve CFTC regulations so that end-users receive fair treatment. I will also discuss several policy initiatives related to customer protection.

Second, I will discuss serious concerns that I have with the Commission's rulemaking process, including the abuse of no-action relief and the lack of strict adherence to the provisions of the Administrative Procedure Act ("APA"). It is my hope that Congress will be able to assist the Commission with imposing discipline on its internal policies and procedures, including amendments to the Commodity Exchange Act ("CEA").

Finally, I will discuss challenges in CFTC data utilization and the importance of technology in meeting the Commission's greatly expanded surveillance and oversight responsibilities under the sweeping reforms enacted by the Dodd-Frank Act.

I. Improving CFTC Regulations Under the Dodd-Frank Act

Protecting Commercial End-Users in Hedging and Mitigating Risk

Even a brief review of the legislative history of the Dodd-Frank Act demonstrates that it was Congress' intent to protect commercial end-users from Dodd-Frank's expansive regulatory reach. Many end-users assumed that CFTC regulations would not affect them and supported aspects of reform, without realizing the policy approach that the Commission would take in implementing the Dodd-Frank Act.

Excluding End-Users from the Swap Dealer Definition

The swap dealer rule is a good example of how the Commission failed to accurately interpret Dodd-Frank by broadly applying the swap dealer definition to all market participants and ignoring the express statutory mandate to exclude end-users from its reach.[3] Instead, the swap dealer rule makes it unnecessarily difficult to determine whether an entity is a swap dealer or an end-user. For example, rather than providing for a clear bright-line test, the swap dealer rule lists numerous factors that should be considered.

Further, as I noted in my dissent to the swap dealer rule,[4] the rule exclusively implements the swap dealer definition provided by the Dodd-Frank Act in section 1a(49)(A) of the CEA,[5] and fails to implement the exclusion for persons that are not engaged in swaps trading as part of "a regular business" in section 1a(49)(C).[6] Not only that, but the Commission also failed to interpret section 1a(49)(B) of the CEA, which provides express authority for the Commission to exclude specific entities from the dealing definition for "types, classes or categories of swaps," such as physical commodities.[7]

As a result, because the rule's swap dealer definition focuses on characteristics of entities rather than their activities and ignores two important exclusions, it captures commercial end-users even though their activities involve hedging and risk mitigation and have nothing to do with swap dealing activities. As a result, end-users have to seek numerous exemptions from various CFTC regulations. This inefficient regulatory process creates uncertainty for end-users and increases the costs of hedging and mitigating risk.

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[2] *http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf* at 9.

[3] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 *FR* 30595 at 30744 (May 23, 2012).

[4] Statement of Dissent, Commissioner Scott D. O'Malia (April 18, 2012), available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement041812b.*

[5] 7 U.S.C. § 1a(49)(A).

[6] 7 U.S.C. § 1a(49)(C).

[7] 7 U.S.C. § 1a(49)(B).

This concerns me even more because Members of Congress who drafted the Dodd-Frank Act repeatedly attempted to make it clear to the Commission that commercial end-users should be exempted from Dodd-Frank's swap provisions. In June 2010, Senate Banking Committee Chairman Chris Dodd and Senate Agriculture Committee Chairman Blanche Lincoln circulated a joint letter stating, "Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage commercial risks associated with their business."[8] And in March 2012, Senate Agriculture Committee Chairman Debbie Stabenow and House Agriculture Committee Chairman Frank Lucas also sent a joint letter to the Commission to reiterate these points:

> "[I]t is important for the Commission to finalize the swap dealer definition in a manner that is not overly broad, and that will not impose significant new regulations on entities that Congress did not intend to be regulated as swap dealers. The Commission's final rulemaking further defining 'swap dealing' should clearly distinguish swap activities that end-users engage in to hedge or mitigate the commercial risk associated with their businesses, including swaps entered into by end-users to hedge physical commodity price risk, from dealing . . . ."[9]

Unfortunately, the Commission failed to listen to these Congressional directives in its implementation of the swap dealer rule.

Solutions that Remove End-Users from the Swap Dealer Definition

Given the policy challenges that the Commission faces regarding the fair treatment of end-users, I would encourage Congress to expressly exclude end-users from the swap dealer definition. In the alternative, Congress may want to consider other approaches that would both encourage risk-mitigating behavior by end-users and also remove the costly burden imposed by the swap dealer definition. For example, Congress should consider permitting commercial entities to not count any of their swap trades that are cleared toward their *de minimis* swap dealing calculation, and consider applying a consistent definition of hedging activity that allows end-users to mitigate both physical and financial commercial risk.

Fixing Hedging and Clearing

I am concerned that the swap dealer rule does not provide any legal or factual justification for the threshold amounts used in aggregation of swap dealing activity. Under CFTC regulations, a swap dealer does not need to register with the Commission if its aggregate swap dealing activity on a yearly basis is below the arbitrary $8 billion threshold.[10] The threshold is then reduced to $3 billion after a 5 year phase-in period.[11] The Commission has failed to support this decision with a fact-based rationale and has made the reduction of the threshold amount non-discretionary, instead of allowing a future Commission to determine the appropriate *de minimis* levels based on market conditions at that time.

In calculating the *de minimis* threshold, market participants are permitted to exclude trades that are executed to hedge physical positions.[12] But for some reason, the Commission's definition of "hedging activity" is different from the definition used in other rules.[13] For purposes of both simplicity and consistency, the Commission should adopt one uniform definition of hedging for all CFTC regulations, and the same definition of hedging should be applied to both swap dealers ("SDs") and major swap participants ("MSPs"). I would welcome Congressional action to clarify the scope and level of permissible hedging activity, which is the foundation of the swaps and futures markets.

Swaps used to hedge risk are not the only category of transactions that should be removed from the $8 billion *de minimis* threshold amount. Swap transactions that are cleared through a derivatives clearing organization ("DCO") mitigate risk and ensure that both parties deal at arm's length. Accordingly, these cleared swaps

[8] Letter from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Collin Peterson (June 30, 2010).

[9] Letter from Senator Debbie Stabenow and Congressman Frank Lucas to CFTC Chairman Gary Gensler (March 29, 2012).

[10] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 *FR* 30595 at 30634 (May 23, 2012).

[11] *Id.* at 30744.

[12] 17 CFR § 1.3(ggg)(6)(iii) (excluding swap transaction entered into to hedge physical positions from the *de minimis* swap dealer calculation).

[13] *See* §§ 1.3(z) and 151.5 (defining *bona fide* hedge transactions in the context of position limits), § 1.3(kkk) (defining hedging or mitigating commercial risk in the context of the major swap participant *de minimis* calculation), § 50.50 (defining hedging or mitigating commercial risk in the context of clearing exceptions).

should also be excluded from the *de minimis* calculation either by the Commission or by Congressional action.

Defining "Financial Entity" in the CEA

Another major issue that Congress needs to address is the definition of "financial entity" in section 2(h) of the CEA, which addresses mandatory clearing.[14] This provision includes the definition of a financial entity as a person "predominantly engaged" in either activities that are within "the business of banking" or "activities that are financial in nature" as defined in the Bank Holding Company Act ("BHCA").[15] The term "financial entity" has material significance throughout Title VII and affects not only these entities' domestic operations, but also has global impact due to the recent cross-border swaps guidance.

Unfortunately, using the BHCA as the source of this part of the definition of financial entity actually hurts end-users because certain technical aspects of end-users' physical commodities transactions would fall under the banking regulators' interpretation of "activities that are financial in nature." Using the definition of "financial in nature" under the banking laws applies unnecessary restrictions to these end-users and interferes with their business operations. The definition also interferes with the Commission's mandate to ensure that the commodity markets are liquid and promote hedging and price discovery. It would be helpful if Congress could clarify the definition of "financial entity" under the CEA.

As an alternative solution, section 102(a)(6) of the Dodd-Frank Act sets forth a predominance test to determine whether or not a firm is a "nonbank financial company." The statute applies an 85% standard for gross revenue from financial activity to determine if a company is predominantly engaged in financial activities, and ultimately, a nonbank financial company. One could assume from this standard that a *de minimis* amount is, therefore, less than 15% of gross revenue from non-financial activity. Accordingly, I wonder whether the Commission should apply a similar 85/15 standard as part of our *de minimis* exception in order to provide a bright-line test for end-users (both commercial and non-bank financial) to demarcate themselves from swap dealers.

Excluding Forward Contracts with Volumetric Optionality from Swap Definition

Another example where CFTC regulations have unnecessarily complicated common commercial transactions, and confounded end-users who want to both comply with the law and use volumetric options in their regular business, is the treatment of volumetric options in the swap definition.

The definition of swap is fundamental to CFTC regulations that oversee the derivatives markets and mitigate systemic risk. Determining whether a contract is a swap affects the determination of swap dealer registration, position limits calculations, the scope of the *bona fide* hedge exemption, and clearing and reporting requirements. Equally important to the definition of swap is ensuring that it does not capture the legitimate business activity of end-users.

Dodd-Frank explicitly excludes forward contracts from the definition of "swap."[16] As you know, flexibility of the terms of commodity forward contracts is essential for commercial end-users. The parties cannot always accurately predict the required needs of certain commodities at some point in the future to meet their business needs.

Unfortunately, the Commission has created a lot of confusion as to whether and under what conditions forward contracts containing terms that provide for some form of flexibility in delivered volumes (*i.e.,* contracts with "embedded volumetric optionality") fall within the forward exclusion.

The swap definition rule suggests that an agreement with embedded optionality falls within the forward exclusion when seven criteria are met. The seventh criterion, however, caused a lot of anxiety among end-users. In essence, the Commission interpreted this criterion as requiring market participants to determine whether their exercise or non-exercise of volumetric optionality is based on factors outside their control and not on the economics of the option itself.[17] This interpretation makes no commercial sense and does not achieve any objectives of Dodd-Frank.

Needless to say, the Commission's ambiguous interpretation of the seventh criterion has made it very difficult for end-users to utilize volumetric optionality with-

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[14] 7 U.S.C. § 2(h)(7)(C)(i)(VIII).

[15] *Id.*

[16] 7 U.S.C. § 1a(47)(B)(ii).

[17] The seventh criterion states that the exclusion applies only when "[t]he exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and influencing demand for, or supply of the nonfinancial commodity." 77 *FR* 48208 at 48238 n. 341 (Aug. 13, 2012).

out the fear of being dragged into the swaps world. A number of end-users requested that the Commission provide clarity on this issue.[18] So far, the Commission has ignored their requests. Given the importance of these contracts, I believe that the forward-contract exclusion in section 1a(47)(B)(ii) of the CEA should be amended to exclude these types of forward contracts from the swap definition.

Raising the *De Minimis* Threshold for Special Entities

Another group that deserves to be reevaluated for fair treatment is state, city, and county municipalities that fall within the swap dealer rule as "Special Entities." As currently drafted, the rule discourages market participants from trading with Special Entities. When trading with municipal energy companies, the $8 billion *de minimis* threshold drops to only $25 million.[19] The reasoning behind this distinction was that Special Entities need even more protection because any loss incurred by a Special Entity would result in the public being left holding the bag.[20] While this rule was written with the best of intentions, by reducing the *de minimis* threshold to $25 million, the end result has been a reduction in the number of market participants that are willing to do business with Special Entities. Many counterparties that would fall well below the $8 billion *de minimis* threshold are not willing to trade with Special Entities for fear of exceeding the $25 million cap and then having to register with the Commission as swap dealers.

In a quick fix to repeated requests from various Special Entities, the Commission issued no-action relief allowing the *de minimis* threshold to be increased to $800 million for utility commodity swaps.[21] In trying to protect Special Entities from the perils of trading in the swaps market, we have forced them to trade with large Wall Street banks since no other entity is willing to trade with them for fear of becoming a swap dealer. Instead of providing them with greater protection, the Commission has limited the pool of counterparties with which Special Entities can trade, concentrating risk in fewer market participants. This plainly goes against the goal of reducing systemic risk.

Exempting Cooperatives from Clearing Certain Swaps

On a more positive note, I am pleased that the Commission has provided cooperatives representing smaller financial institutions, such as credit unions or farm credit organizations, an exemption for clearing certain swaps. The smaller institutions themselves have already been exempted, but after receiving requests from the cooperatives that represent groups of such organizations, the Commission has exempted them as well. Cooperatives act on behalf of their members, the end-users, when they transact in the financial markets. Therefore, the same clearing exemption should be available to these groups.

Incidentally, at least in the energy markets, traders have moved to the futures market to avoid the onerous swap dealer definition. Trading futures doesn't contribute to any swap dealer *de minimis* levels and all futures trades are cleared, thus mitigating counter party risk. This brings me to my next area of discussion—futurization.

Futurization of Swaps

As a good example of the effect of the complexity and regulatory uncertainty created by CFTC regulations implementing the Dodd-Frank Act, commercial end-users moved the lion's share of swaps trading to the futures markets. Last year, on October 15, 2012, which is the day that the swap dealer and swap definition rules took effect, the IntercontinentalExchange ("ICE") converted all of its energy swaps into futures as requested by their customers. The exact same products that were swaps the day before were traded seamlessly as futures on a designated contract market ("DCM").

There are three main drivers behind futurization: (1) vague and over-inclusive swap dealer definition rules as I mentioned earlier, (2) the Commission's differential regulatory treatment of futures *vis à vis* swaps with respect to the margining requirements and (3) margin requirements for swaps.

[18] *See, e.g.,* National Gas Supply Association Comment Letter (Oct. 12, 2012), American Petroleum Institute Comment Letter (Oct. 11, 2012), Edison Electric Institute Comment Letter (Oct. 12, 2012).

[19] 77 *FR* 48208 at 30642, 30744.

[20] *Id.* at 30628 (referring to documented cases of municipalities losing millions of dollars on swaps transactions because they did not fully understand the underlying risks of the instrument).

[21] Staff No-Action Relief: Temporary Relief from the De Minimis Threshold for Certain Swaps with Special Entities, October 12, 2012.

With respect to margining, futures are margined assuming a 1 or 2 day liquidation period.[22] However, swaps (except for energy and agricultural swaps) require a minimum liquidation period of 5 days for calculating initial margin.[23] The margin is set based on a liquidation period in order to cover potential losses on a defaulted position before that position can be liquidated by the clearinghouse. This substantially higher margin for swaps results in a significant economic disadvantage to swaps contracts compared to futures contracts that have similar economic characteristics. Such differential treatment of economically equivalent contracts, simply because one is called a "swap" and the other is called a "future," makes no sense from a risk management standpoint. Instead, the liquidation period should depend on the economic characteristics of a particular contract (regardless of whether it is a swap or future) and the level of liquidity of that contract. All of these conditions should the same for two economically equivalent contracts.

Historically, the Commission has allowed DCOs to set the minimum liquidation time horizons and the Commission has relied entirely on the expertise of clearing houses to set all margin levels. Allowing the clearinghouse to set the risk, rather than the Commission's prescribing rules with arbitrary time periods, is more appropriate because of the risk management functions of clearinghouses. There is also no incentive for a DCO to lower margin levels because the DCO ultimately bears the loss for any of its members' default.

Harmonizing Capital and Margin Requirements for OTC Swaps

Another rule that is yet to be finalized that impacts end-users' activities is the capital and margin requirements for OTC swaps. In their letter, Senators Dodd and Lincoln point out that "Congress clearly stated that the margin and capital requirements are not to be imposed on end-users." [24]

On April 13, 2011, the Commission proposed rules regarding capital and margin requirements for uncleared swaps.[25] I supported the proposal and the exemptive relief that rule would provide to end-users. Under the proposal, when swap dealers trade with end-users, the swap dealer is not required to pay or collect initial or variation margin. This is consistent with Congressional intent.

While the margin rules, as proposed, would provide some relief to end-users, I believe end-users will be required to take a capital charge. The final result is that end-users will ultimately pay more for these transactions than they did before. It is imperative that the Commission's regulations not divert working capital into margin accounts in a way that would discourage hedging by end-users or impair economic growth. Whether swaps are used by an airline hedging its fuel costs or a manufacturing company hedging its interest rates, derivatives are an important tool that companies use to manage costs and market volatility. I agree with Sean Owens, an economist with Woodbine Associates, who stated that under the Dodd-Frank rules, "end-users face a tradeoff between efficient, cost-effective risk transfer and the need for hedge customization. The costs implicit in this tradeoff include: regulatory capital, funding initial margin, market liquidity and structural factors." [26]

Swap Execution Facilities

Another rule that could potentially impact end-users is the Commission's swap execution facility ("SEF") rulemaking that was finalized by the Commission in June.[27] I am pleased that in some ways, the SEF rules have made great strides to allow for a smooth transition to this new trading environment. The rules provide a streamlined registration process and allow for flexible methods of execution, but it remains to be seen whether the Commission will be able to deliver on the requirements to approve temporary SEF registration on an expedited basis. Now, it is incumbent upon the Commission to move quickly, consistently, and transparently to approve SEF applications and provide market participants adequate time to test the new trading facilities, before mandatory trading requirements are effective.

In many ways, the final rule is consistent with the goals of the SEF clarification bill as it acknowledges the "any means of interstate commerce" clause contained in the SEF definition and provides for a role of voice and other means of execution. I am aware that the final rules may have created an uneven playing field for those SEFs that are trading products that are not required to be traded on a SEF. The

[22] 17 CFR § 39.13(g)(2)(ii)(A).
[23] 17 CFR § 39.13(g)(2)(ii)(C).
[24] Letter from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Collin Peterson (June 30, 2010).
[25] 76 *FR* 23732 (April 13, 2011).
[26] *See* Sean Owens, *Optimizing the Cost of Customization, Review of Futures Market* (Jul. 2012).
[27] 78 *FR* 3347 (June 6, 2013).

rule requires all multilateral facilities to register as a SEF and comply with all the regulatory requirements if they trade these products, while platforms that have one-to-many facilities are not required to register with the Commission and are allowed to offer these products for trading. I believe the Commission should address this regulatory arbitrage as soon as possible to establish a level playing field for the new swap execution platforms.

Protecting Customers in FCM Bankruptcy Proceedings

I have now identified several areas where the Commission's policy approach and rule implementation have failed to appropriately exclude commercial end-users from the more onerous aspects of the Dodd-Frank Act that address systemic risk, and offered suggestions to solve these challenges. But in the important area of customer protection, there are a couple issues where the Commission could use help from Congress.

Lessons Learned from MF Global and Peregrine

The importance of customer protection is emphasized by the recent cases involving the blatant misuse of customer funds by futures commission merchants ("FCMs"). In 2010, MF Global misappropriated over $900 million in customer funds in order to cover losses incurred by the FCM in its own proprietary trading accounts. This was made worse by the $700 million in funds that were held in MF Global's UK affiliate that remained out of reach of U.S. customers that were entitled to these funds. It goes without saying that this was a devastating loss to the customers of MF Global.

One year later, Peregrine Financial Group and its founder and chief executive Russell Wassendorf were found to have misappropriated over $200 million in customer funds. In light of these sizable and high profile cases of FCM misconduct, both the industry and Commission have taken steps to increase the level of protection afforded to customer assets to prevent something like this from happening again.

It is inexcusable that these FCMs failed to protect customer funds. These violations were not because of a lack of regulation, but were due to the failure of these FCMs to comply with rules under the CEA. In both cases, the Commission used its enforcement authority to prosecute those responsible at these FCMs. In the case of MF Global, the Commission recently filed a law suit against Jon Corzine and Edith O'Brien that has not yet gone to trial.[28] But importantly, customers have fared better in recovering their funds that were misused. Today, customers are expected to recover approximately 96 percent of their funds,[29] albeit 3 years after wrongdoing was discovered. In the case of Peregrine Financial, Russell Wassendorf was convicted of mail fraud, embezzlement, and making false statements to the CFTC and the National Futures Association. Regrettably, however, customers of Peregrine continue to seek repayment of the more than $200 million in customer funds that were stolen by Mr. Wassendorf.

As I noted earlier, the Commission did have regulations in place to make these actions by the respective CEOs unlawful.[30] Even so, I believe there are opportunities to make improvements in Commission oversight of customer funds. As I mention in more detail below, I believe Congress should carefully consider improving customer protections in the event of FCM insolvency.

Creating a Bankruptcy Trustee for Futures and Swaps Customers

Let me first address post-bankruptcy reforms. Since over 90% of customer assets that are held in FCMs are held by jointly registered and regulated broker-dealers/FCMs, I would support increasing the authority of the CFTC in the insolvency proceedings for these jointly-regulated entities. For example, in the case of MF Global, the Securities Investor Protection Corporation ("SIPC") placed the firm into bankruptcy, with SIPC as its trustee and the exclusive mandate to protect securities customers. Since the interests of futures customers may not align with securities investors, it makes sense for the Commission to have the power to appoint its own trustee who is familiar with the CEA.

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[28] *http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfmfglobalcomplaint062713.pdf.*

[29] While futures customers of MF Global are expected to receive 96% of their assets, MF Global customers that had foreign investments are expected to recover between 84–91% of their assets.

[30] *See* 7 U.S.C. § 13c(b).

Ensuring that Customers Come First: "Super Lien" Reforms

Further, I believe Congress should pursue granting new authority to the Commission in the U.S. Bankruptcy Code to ensure that customers are always first in order of priority in any distribution of assets of the estate by the bankruptcy trustee. Claiming customers are first in line only within the FCM is not enough, especially if they are deemed a general creditor amongst the other claimants against the holding company. The reality is—and this was the case in MF Global—that the decision of the CEO of the controlling parent company can directly impact the operation of the FCM and, therefore, its customers. By making customers first in line for the proprietary assets of the FCM and its controlling parent, the company has every incentive to strengthen its internal controls to protect customer funds. And creditors, knowing their claims would be subordinate to customers in the event of a shortfall in the bankruptcy accounting, would also be incentivized to ensure good internal controls are in place.

Reconsidering *Pro Rata* Distribution for Customers

Next, I believe Congress should carefully consider the *pro-rata* distribution rules in bankruptcy proceedings, including creating the opportunity for certain entities (that are willing to purchase such protection) the ability to establish third-party segregation accounts that will not be commingled in bankruptcy. Currently, if there is a shortfall in segregation, customers share the loss proportionally.[31] This is the law whether or not customer funds are held in one account (commingled) or in a separate individual account. The Commission has explored various options, but has been unable to change the *pro-rata* requirements without statutory amendments.

Rulemaking on FCM Residual Interest

The Commission has also proposed a new customer protection rule seeking to improve the Commission's FCM oversight.[32] The comment period is closed and the draft final rule is nearing completion. One element of this rule that has drawn significant attention is the rule changing the Commission's interpretation of residual interest. The practical effect of this rule would require FCMs to maintain a level of excess margin so that one customer's excess margin does not fund the margin shortfall of another customer 100 percent of the time. While the clearing house will view the FCM's omnibus account as being properly funded,[33] one customer's assets are being used to fund another's shortfall, which is a direct violation of the CEA.[34]

We have heard significant concerns from small FCMs in the Midwest who serve farmers and ranchers in agriculture markets. The small FCMs are less likely to be able to cover the additional funds, unlike larger firms. This could result in less competition and higher concentration of risk and counterparty exposure among FCMs.

II. Improving CFTC Policies and Procedures

I have now identified several examples where the Commission's policy approach has resulted in negatively impacting commercial end-users in a way that I do not believe Congress intended, and outlined solutions to get us back on track with our mission to protect market participants and ensure open, competitive markets that efficiently hedge risk and foster price discovery. But, it is virtually impossible to achieve good policy outcomes without establishing a sound process for reaching those outcomes. Unfortunately, the Commission has failed to do so in our implementation of the Dodd-Frank Act.

[31] *See* 11 U.S.C. § 766(h).

[32] *See* Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations; Proposed Rule, 77 *FR* 67866 at 67934 (Nov. 14, 2012).

[33] This is better illustrated by means of an example: FCM A has customers B and C. Customer B has a long futures position that requires $110 in margin. Customer C has a short futures position that requires only $100 in margin. FCM A then reports these positions to the clearing house within its single customer account without identifying the individual customer positions. Since the clearing house views this as one single account, it views FCM A as having a $10 surplus. In the event Customer C's position reduces in value to the point that additional margin is required, FCM A should collect that amount directly from Customer C. If the loss in C's position only requires an additional margin contribution of $10 or less however, FCM A could use the $10 excess in Customer B's account to fund Customer C's deficiency until it collects that additional margin requirement from Customer C at a later date.

[34] "It shall be unlawful for any person to be a futures commission merchant unless . . . such person shall . . . treat and deal with all money . . . received by such person to margin . . . the trades . . . of any customer of such person . . . as belonging to such customer." 7 U.S.C. § 6d(a)(2).

I have serious concerns that the Commission has sidestepped many requirements that all administrative agencies must follow under the APA.[35] I believe that strong Congressional oversight of our internal policies and procedures and strong Commission oversight of CFTC staff action will help us to improve our process, ensure that public participation is a core component in our deliberations, and that decisions that significantly impact market participants happen in an open and transparent manner.

Administrative Procedure Act

For example, the Commission's position limits rule was struck down last year by the United States District Court for the District of Columbia. The court held that before setting position limits, the Commission is required by statute to determine whether position limits were "necessary and appropriate" to prevent excessive speculation in the commodity markets. Unfortunately, the Commission ignored the district court order to undertake the required analysis and is gearing up to defend the position limits rule in the United States Court of Appeals for the District of Columbia Circuit. Concurrently with its appeal, the Commission is drafting a new rule all over again, instead of simply evaluating the necessity for position limits as it should have done in the first place. I believe that the district court sent a strong message to the Commission in its decision to vacate the position limits rule, namely, that the Commission must carefully follow the letter of the law in its rulemaking and that shortcuts will not be tolerated. Instead of heeding the warning of the district court and recent DC Circuit opinions vacating SEC rules for violating the APA, the Commission has chosen to skirt the requirements of the APA.

Abusing No-Action Relief

To date, the Commission has promulgated 45 final rules, three interim final rules, and four interpretive statements in its implementation of the Dodd-Frank Act.[36] However, in its haste, the Commission has finalized some rules that are either unworkable or simply make no sense. As a result, the Commission has also had to adopt seven exemptive orders related to Dodd-Frank requirements.[37]

Not only that, but instead of undertaking Commission action to amend problematic rules, CFTC staff has issued an unprecedented number of no-action letters, some of which are indefinite and have no expiration. So far, CFTC staff has issued over 100 no-action letters granting relief from its new regulations under Dodd-Frank, and I won't be surprised if this number continues to grow.[38] No-action letters are not voted on by the Commission and are not published in the *Federal Register*. They do not include comment periods and many impose conditions on affected parties. This process is at odds with basic principles of the APA, like public participation and the opportunity to be heard. It also goes against President Obama's Executive Orders Nos. 13563 and 13579, mandating that administrative agencies "create an unprecedented level of openness in Government" and "establish a system of transparency, public participation, and collaboration."[39]

I believe that the use of the no-action relief process by CFTC staff is inappropriate for changes in Commission policy. A no-action letter is issued by a division of the CFTC and states that, for the reasons and under the conditions described therein, the staff will not recommend that the Commission commence an enforcement action against an entity or group of entities for failure to comply with obligations imposed by CFTC regulations. Although the relief is not available to all entities, usually because of some complicated precondition, those market participants that may benefit from the relief are subject to numerous other conditions, needless restrictions, and arbitrary compliance timelines.

A stark example of the inappropriateness of no-action letters to grant relief is demonstrated by the recent CFTC staff no-action letter allowing substituted compliance for certain foreign jurisdictions from the Commission's cross-border swaps guidance.[40] I am concerned that a staff letter issued by a single division, with no input or vote from the Commission, would be used as the vehicle for addressing such a major issue. This no-action letter is outside the scope of a forthcoming Com-

[35] 5 U.S.C. §§ 551 *et seq.*

[36] *http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/index.htm.*

[37] *Id.*

[38] *http://www.cftc.gov/LawRegulation/CFTCStaffLetters/No-ActionLetters/index.htm.*

[39] Executive Order 13563, "Improving Regulation and Regulatory Overview," (Jan. 18, 2011); Executive Order 13579, "Regulation and Independent Regulatory Agencies," (Jul. 14, 2011).

[40] No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of CFTC regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR, CFTC Letter No. 13–45 (July 11, 2013).

mission decision regarding the comparability of European rules. Further, because the relief is not time-limited, it creates an effect similar to a rulemaking but does not go through notice-and-comment procedures. As a result, this indefinite exemption not only preemptively overrides a Commission decision, but also seems to conflict with provisions in the cross-border swaps guidance that call for a re-evaluation of all substituted compliance determinations within 4 years of the initial determination.

Unfortunately, this is not the first time that CFTC staff no-action letters have been used to set forth Commission policy under Dodd-Frank. Staff no-action letters are inappropriate because they are not voted on by the Commission and are not formal Commission action. They are not binding on the Commission, but affected parties comply with their conditions despite the lack of legal certainty due to practical business considerations, even though the Commission may later decide to pursue enforcement or other prejudicial action. I believe that the prolific use of no-action relief relating to Dodd-Frank provisions reflects the *ad-hoc* and last-minute policy approach that has been far too prevalent lately at the Commission. The Commission must stop this approach and get back to issuing policy in a more formal, open and transparent manner.

The Commission cannot continue with its reactive regulatory oversight. It must re-visit the rules that have proved to be unworkable, incorporate indefinite permanent relief into amended rules, make necessary adjustments, and consistently and fairly apply such amended rules to all regulated entities.

Violating Notice-and-Comment Requirements

Another serious concern I have with the Commission's rulemaking process is the lack of notice-and-comment procedures. For example, and also in connection with its cross-border swaps guidance, the Commission recently issued an exemptive order that excludes certain foreign entities from the definition of "U.S. person" and, therefore, from compliance with the CFTC swap regulations. Even though this exemptive order goes into effect immediately, the Commission has included a post-*hoc* 30 day comment period. I am concerned that this final exemptive order should have complied with notice-and-comment requirements under the APA that allow parties to be heard before binding rules go into effect. I am also concerned that the Commission may be inappropriately using a good-cause exception to the APA to get around notice-and-comment requirements that are supposed to ensure careful and well-reasoned decision-making.[41]

Issuing Interpretive Guidance *Versus* Rulemaking

I believe that the recent cross-border swaps guidance is also an example of yet another way the Commission's recent approach to implementing its policy has minimized public participation, open engagement, and the deliberative process from our rulemakings. By issuing interpretive guidance, and then having staff issue no-action relief that exempts a large class of persons and imposes conditions without a Commission vote, the Commission evades both APA requirements and cost-benefit analysis.

I believe that putting the label of "guidance" on this document did not change its content or consequences. The courts have held that when agency action has the practical effect of binding parties within its scope, it has the force and effect of law, regardless of the name it is given.[42] Legally binding regulations that impose new

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[41] Section 553(b)(B) of the APA provides for a good-cause exception to notice-and-comment requirements: "*Except when notice and hearing is required by statute,* this subsection does not apply . . . (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest." 5 U.S.C. § 553(b)(B) (emphasis added). However, section 4(c) of the CEA clearly provides that the Commission may grant exemptive relief only by "rule, regulation, or order *after notice and opportunity for hearing*" (emphasis added). 7 U.S.C. § 6(c). The APA further provides under section 559 that it does not "limit or repeal additional requirements imposed by statute or otherwise recognized by law." 5 U.S.C. § 559. The CEA also grants emergency powers to the Commission under exigent circumstances. *See, e.g.,* 7 U.S.C. § 12a(9). In addition, courts have narrowly construed the good-cause exception and placed the burden of proof on the agency. *See, Tenn. Gas Pipeline Co.* v. *Fed. Energy Regulatory Comm'n,* 969 F.2d 1141 (D.C. Cir. 1992); *Guardian Fed. Sav. & Loan Ass'n* v. *Fed. Sav. & Loan Ins. Corp.,* 589 F.2d 658, 663 (D.C. Cir. 1978).

[42] *See Gen. Elec. Co.* v. *Envtl. Prot. Agency,* 290 F.3d 377, 380 (D.C. Cir. 2002) (finding that a guidance document is final agency action); *Appalachian Power Co.* v. *Envt. Prot. Agency,* 208 F.3d 1015, 1020–21 (D.C. Cir. 2000).

obligations on affected parties—"legislative rules"—must conform to the APA.[43] As a threshold matter, the cross-border swaps guidance rests on thin statutory authority, because Congress limited the extraterritorial application of U.S. swap regulations, and therefore the CFTC's jurisdiction, to foreign activities that have a "direct and significant" impact on the U.S. economy. Despite the statutory limitation, the cross-border swaps guidance sets out standards that it applies to virtually all cross-border activities in the swaps markets, in a broad manner similar to the application of the swap dealer definition to market participants. For practical reasons, market participants cannot afford to ignore detailed regulations imposed upon their activities that may result in enforcement or other penalizing action.[44] Accordingly, I believe that the cross-border swaps guidance has a practical binding effect on market participants and it should have been promulgated as a legislative rule under the APA. Similarly, I cannot support any future interpretive guidance that would be more properly issued as a notice-and-comment rulemaking.

Avoiding Cost-Benefit Analysis

Further, by issuing interpretive guidance instead of rulemaking, the Commission has also avoided analyzing the costs and benefits of its actions pursuant to section 15(a) of the CEA,[45] because the CEA requires the Commission to consider costs and benefits only in connection with its promulgation of regulations and orders. Compliance with the Commission's swaps regulations entails significant costs for market participants. Avoiding cost-benefit analysis by labeling the document as guidance is unacceptable.

I have always advocated that the Commission's rulemaking must include a thorough cost-benefit analysis, both qualitative and quantitative, to ensure that new rules do not impose unreasonable costs on the public. Frankly, the Commission's cost-benefit provision in the CEA does not require the Commission to undertake any quantitative analyses of its proposed rules. Last year, the CFTC Inspector General found that the Commission used inadequate cost-benefit methodology for the adoption of regulations implementing the derivatives provisions of Dodd-Frank. The study found that the CFTC General Counsel played a dominant role in the cost-benefit analysis to the derogation of the CFTC Chief Economist, which has been detrimental to other agency rulemakings.

Rigorous cost-benefit analysis is simply a common sense tool designed to ensure that the benefits of any regulation exceed its costs and that regulators adopt the least burdensome approach to achieve the desired regulatory outcome. I am pleased to see that the House has passed a cost-benefit analysis bill amending the CEA and requiring the Commission to conduct quantitative economic analysis on its rules. In essence, the United States Court of Appeals for the District of Columbia Circuit found that the Commission's cost-benefit determination in connection with its recent commodity pool operator/commodity trading advisor ("CPO/CTA") rules, which lacked quantitative analysis, was in compliance with section 15(a) of the CEA because the statute imposes few requirements to quantify or estimate the cost of Commission rule proposals in favor of very high level, theoretical impacts.[46]

Even though the Commission has nearly completed its rulemaking to implement the Dodd-Frank Act, I believe it makes sense for Congress to draft and pass new, more specific cost-benefit analysis requirements for the Commission to ensure that future regulations undergo a quantitative and qualitative analysis that is consistent with the cost-benefit standards applied by other Federal Government agencies in their rulemaking. I support Chairman Conaway's bill H.R. 1003 as it would require the Commission to conduct a higher standard of analysis than has been previously utilized.

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[43] *See Chrysler Corp.* v. *Brown,* 441 U.S. 281, 302–03 (1979) (agency rulemaking with the force and effect of law must be promulgated pursuant to the procedural requirements of the APA).

[44] "A document will have practical binding effect before it is actually applied if the affected private parties are reasonably led to believe that failure to conform will bring adverse consequences . . . ." *Gen. Elec.,* 290 F.3d at 383 (quoting Anthony, Robert A., *Interpretive Rules, Policy Statements, Guidances, Manuals, and the Like—Should Federal Agencies Use Them to Bind the Public?,* 41 Duke L. J. 1311 (1992)) (vacating an agency's guidance document that the court found to have practical binding effect and where procedures under the APA were not followed).

[45] 7 U.S.C. § 19(a).

[46] *Inv. Co. Inst.* v. *Commodity Futures Trading Comm'n,* No. 12–5413, Slip. Op at 14 (D.C. Cir. June 25, 2013) (stating that "[t]he statute only requires the Commission to address costs and benefits" and that the Commission does not "need [to] count costs" because the statute does not "mandate" it).

Internal Policies and Procedures

One area of concern that I would like to draw to your attention is the importance of a strong Commission that faithfully adheres to our principles of democratic government. Each of the five Commissioners is appointed by the President, with the advice and consent of the Senate, to carry out the mission of the CFTC to supervise the commodity markets. I am concerned that we have strayed from faithfully executing this directive as a Commission that is fully accountable to Congress and the public.

When I first arrived at the Commission in 2009, fellow Commissioner Mike Dunn, a distinguished public servant for many years, impressed upon me the importance of consistency and transparency in order to achieve good government and policy outcomes. I believe that we have lost sight of these guiding principles in our rush to implement the Dodd-Frank Act.

Stronger Commission Oversight of CFTC Staff Action

CFTC regulations ensure that the Commission is made accountable for all enforcement matters by requiring a Commission order to initiate investigations by the Division of Enforcement. Just recently, I dissented on an enforcement matter that involved a radical procedural shift in the authorization of investigations for potential violations of the CEA. What I found troubling is that the Division of Enforcement sought to circumvent the powers of the Commission by proposing to bring investigations on a summary basis through the use of an "absent objection" process. I was surprised to be advised by the Commission's Office of General Counsel that the Commission cannot block a staff-initiated absent objection circulation because this process is not a Commission "vote."

To ensure fairness in terms of true separation of functions, Congress gave power to the members of the Commission to reconsider CFTC staff recommendations by independently assessing facts and legal justifications for initiating various actions. In other words, Congress intended that any decision to bring an investigation by the CFTC is reflective of a shared opinion of the majority of the Commissioners, rather than a unilateral assessment by the Division of Enforcement's staff. The new absent objection process described by the Office of General Counsel is a clear abrogation of the Commission's powers and a violation of Commission rules relating to investigations.[47]

While I support the Division of Enforcement's efforts to expeditiously investigate possible fraudulent activity, I also recognize that the Commission possesses certain responsibilities to execute its law-enforcement powers and that these responsibilities should not be brushed off to achieve an "efficient" investigative process.

Stronger Congressional Oversight of Commission Action

Congressional oversight will help to instill discipline in our internal policies and procedures. I believe the following is necessary: (1) Congress should demand a full review of the Commission's policies and procedures for Commission action and interpretation of the CEA and (2) the Commission should adopt policies and procedures that are identified to ensure that no-action relief is not abused, restore a strong Commission with appropriate accountability to the public, require the basic application of APA notice-and-comment procedures, and undertake rigorous cost-benefit analysis review. If Congress is dissatisfied with the Commission's past practices and procedures, I believe that Congress should enact reforms to the CEA to impose discipline on the Commission so that it complies with the APA and other laws.

III. Improving CFTC Utilization of Data and Technology

A critically important component to any solution for the Commission's approach to its greatly expanded mission is the use of technology in order to accept, sort, aggregate, and analyze the new sources of market information provided for under the Dodd-Frank Act. I'd like to highlight two major challenges in data and technology: (1) problems faced by market participants in the swap data reporting rules and (2) problems faced by the Commission in understanding the massive data flows as a result of our enhanced oversight of the swaps and futures markets.

Challenges in Swap Data Reporting Rules

I would like to bring the Commission's approach to swap data reporting to your attention as an illustrative example of the Commission's rulemaking getting in the way of our mission to oversee trading activity and mitigate systemic risk. CFTC

[47] 17 CFR § 11.4 (stating that the *Commission* is authorized to issue a subpoena) (emphasis added).

rules have seriously impaired the Commission's ability to effectively and immediately monitor the markets and conduct its expanded oversight responsibilities.

Under the Dodd-Frank Act, swaps data must be reported in two forms. First, basic data on swap transactions such as time, price, and notional size must be reported to a swap data repository ("SDR") and must be available to the general public. Second, more detailed and non-public information on uncleared swap transactions must be sent to SDRs under Part 45.[48] This particular swap data would include information on the counterparties to the swap and other detail that is significantly greater than what the public would need to know.

Unfortunately, the Commission failed to follow Dodd-Frank's directives when it implemented its reporting rules. Instead, the Commission required that market participants report *all* swaps, both cleared and uncleared, to SDRs in order to comply with the Commission's regulations.[49] The Commission complicated matters further by failing to definitively state who—the counterparties to the swap, the SEF or DCM on which the swap was traded, or the clearinghouse through which the swap was cleared—had the authority to decide which SDR would receive the data.[50]

The lack of clarity in our regulations, just as in the other examples I previously discussed, has led to both confusion and litigation. This past spring, the Commission was called upon to decide who had the authority to determine which SDR would receive the swap data. CME filed a request for a rule approval that would give them the authority to send swap data to the SDR of their choice. After considering the issue for close to 3 months, the Commission approved CME's new rule.[51] DTCC, a competing SDR, filed suit soon after and claimed the Commission's approval was inconsistent with the Commission's reporting requirements under its swap data reporting rule.[52]

Although correcting the inconsistencies in the Commission's rulemaking is something the Commission must address as soon as possible, there still remains an unresolved issue with respect to cleared swaps. The Dodd-Frank Act did not specifically address regulatory reporting of cleared swap data. I believe Congress should now re-examine the issue and decide if the Commission's current regulations meet both the letter and the spirit of Dodd-Frank.

Repeal of Swap Data Repository Indemnification Requirement

While on the subject of data reporting, I would like to bring up one more important issue. The Dodd-Frank Act requires foreign governments to provide an SDR with an indemnification agreement in order to have direct access to the swap transaction data for counterparties that are within the foreign government's jurisdiction.[53] Needless to say, foreign governments are either prohibited or unlikely to provide an SDR with an indemnification agreement. The Commission cannot require unfettered access to foreign trade repositories until the law is changed and this imbalance is corrected. I am pleased to see that the House has passed the bill addressing the indemnification provision.

Challenges in CFTC Data Utilization

However, even if the Commission fixes its swap data reporting rules, the Commission still lacks the ability to utilize and analyze the regulatory reporting data it receives from SDRs.

Since the beginning of 2013, certain market participants have been required to report their interest-rate and credit index swap trades to a SDR. Unfortunately, the Commission has made very little progress in analyzing and utilizing the data. With the Commission's current technology, things are not going well.

For example, the data submitted to SDRs and, in turn, to the Commission, is not usable in its reported format. Earlier this spring, the Surveillance staff admitted that they couldn't spot the London Whale trades in the Commission's current data files.

This problem is caused by the Commission's failure in its swap data reporting rules to specify the data format that reporting parties must use when sending their swaps to SDRs. In other words, the Commission told the industry what information to report, but didn't specify which language or format to use. As it turned out, re-

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[48] §§ 727, 729 of the Dodd-Frank Act.

[49] *See* Part 45 of the Commission's regulations.

[50] *See* §§ 45.3 and 45.8 of the Commission's regulations that provide seemingly contradictory instructions on which market participants and registered entities have the responsibility for reporting swap transactions.

[51] *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/statementofthecommission.pdf.*

[52] *http://www.dtcc.com/dtcc.v.cftc.pdf.*

[53] See § 728 of the Dodd-Frank Act.

porting parties have their own internal nomenclature that is used to compile swap data. Without a Commission regulation identifying a specific nomenclature that must be used, reporting parties are free to use their own.

The end result is that even when market participants submit the correct data to SDRs, the language received from each reporting party is different. In addition, data is being recorded inconsistently from one dealer to another. Now multiply that number by the number of different fields the rules require market participants to report. Further, the abused no-action process has allowed unidentified gaps to appear in the data without explanation.

Aside from the need to receive more uniform data, the Commission must significantly improve its own IT capability. The Commission has failed to make technology investment a top priority. Our ability to adapt our existing systems to our new data requirements is a major challenge. Consequently, we don't have the capacity to undertake review of order book data, which is critical to spotting manipulative trading schemes.

Solving our data dilemma must be the Commission's top priority. We must focus our attention to both better protecting the data we have collected and developing a strategy to understand it. Until such time, nobody should be under the illusion that promulgation of reporting rules has enhanced the Commission's surveillance capabilities. As Chairman of the Commission's Technology Advisory Committee ("TAC"), I have formed a working group comprised of various market participants, including SDRs and DCOs, to leverage the expertise of this group to resolve this problem as soon as possible.

Challenges in Data Privacy

As I mentioned before, the ability of the Commission to access and analyze transaction data is paramount to the agency's regulatory oversight responsibilities. Access to data is crucial to developing new strategies and surveillance tools, but it comes with an enormous burden of responsibility to protect section 8 data (disclosure of information by the Commission).[54] In our cooperation with foreign regulators to achieve the G20 objectives, the Commission must address access issues and privacy concerns.

Currently the Commission's Inspector General is investigating whether or not market data was properly controlled by the Office of the Chief Economist when visiting scholars/contractors were assisting the Office of the Chief Economist in research efforts. While I support collaborative study programs that bring in new and innovative thinking, it is vital that the Commission has policies and procedures in place to protect against the illegal release of market data. It would not be unreasonable for the Subcommittee to request a thorough review of the Commission's data privacy policies and procedures and a subsequent briefing by the Inspector General when his investigation is complete. Ensuring that the Commission can fulfill its responsibilities under the Dodd-Frank Act constitutes appropriate Congressional oversight. It is also imperative for foreign regulators to have confidence that U.S. policy will protect the data of their citizens, just as we have every right to expect that for U.S. citizens.

Technology Plan: A Solution to Challenges in Data Reporting and Utilization

Given the Commission's expanded regulatory responsibilities, it is imperative for the Commission to develop a technology plan that can assist the Commission with meeting its regulatory objective. I believe the Commission must develop a 5 year strategic plan that is focused on technology, with annual milestones and budgets. To keep up to speed with the challenges of enhanced regulatory oversight, this technology plan would require each CFTC division to develop a technology budget that reflects the regulatory needs and responsibilities of that particular division.

As part of developing the CFTC strategic plan, Commission staff is working with goal teams and divisions to highlight the major technology initiatives by specific goal. These initiatives will form the basis for the IT strategic plan. While I am encouraged by the process, I will wait to review the recommendations before I can say with confidence that the Commission understands both its own shortcomings and immediate priorities, and how it intends to oversee the swaps and futures markets over the next decade.

Like the review of the no-action relief process, this Committee has every right to expect that the Commission develops and explains its strategy for deploying technology. The Commission needs to leave behind its 20th century regulatory ways in order to oversee this modern 21st century marketplace.

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[54] 7 U.S.C. 12(e).

Electronic Monitoring of Customer Fund Balances: Industry Solution Powered by Technology

I'd like to close my testimony by focusing on a success story: the Commission's pursuit of enhancements to its oversight ability by leveraging industry resources. In response to the egregious lack of regulatory compliance exposed by the failures of MF Global and Peregrine, there was a positive and immediate industry response that solved a gaping hole in FCM oversight. Following the Peregrine failure, which exposed the absence of electronic monitoring of customer fund balances held by the FCM and custodian banks, I called an emergency meeting of the TAC. At this meeting, I tasked the National Futures Association ("NFA") and CME, which are the Self-Regulatory Organizations ("SROs") of the FCMs, to develop a technology solution to monitor and reconcile the balances held by the FCMs and custodian banks. I am proud to say that NFA and CME delivered the technology solution. Since January 2013, an automated system linking FCMs and custodian banks has been in place to monitor changes in expected balances to within less than one percent deviation in customer accounts. The system is being expanded to carrying brokers and clearinghouses as well. This new technology capability was not mandated by CFTC regulations and was not paid for by taxpayers. This is a prime example of having industry solutions that protect customers and augment the Commission's oversight ability.

Conclusion

The Commission has been given the momentous task of creating a regulatory environment that increases transparency and improves stability in the financial markets. The Commission, in implementing such broad and ambitious goals, was tasked with transforming Dodd-Frank objectives into a workable regulatory framework. Given the intrinsic complexities of the financial markets, the Commission must come up with clear and consistent rules that take into account the global nature of derivatives trading. Although it is difficult to achieve these goals without making mistakes along the way, when flaws are uncovered, it is imperative for the Commission to work with market participants to come up with better solutions to implementing Dodd-Frank objectives. If the Commission does not faithfully implement the statute or make the necessary conforming updates to its rules, this Committee has every right and responsibility to make the necessary and immediate changes it sees fit. I am happy to continue to work together to provide any information the Subcommittee requires to ensure the Commission is operating as authorized and as mandated by the Dodd-Frank Act.

I appreciate the opportunity to testify today and am happy to answer any of your questions.

Thank you.

The CHAIRMAN. Thank you, Scott. Mark?

STATEMENT OF HON. MARK P. WETJEN, COMMISSIONER, U.S. COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. WETJEN. Good morning, Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee. Thank you for inviting me to testify this morning and share some of my perspectives on the future of the Commodity Futures Trading Commission. It is a pleasure to be here.

I want to personally thank Chairman Conaway for his keen interest in our agency and his open dialogue with me since I joined the Commission. I have found our discussions to be useful and hopefully mutually beneficial.

I also want to acknowledge my friend, Commissioner O'Malia, who is beside me today. I have admired his skills in analyzing and bringing attention to important issues raised by our rules or other market developments. I hope you would agree that we have developed a good working partnership at the agency.

For a host of reasons, now is a very good time for not only this Subcommittee but all stakeholders in the CFTC to reflect on what the future might bring for this agency. Allow me to mention a few.

First, and most obviously, Congress must address the expiring authorization for the agency, which is the primary reason for the hearing today and of course will require a Congressional response. I appreciate the Subcommittee's efforts to work toward making that response an informed one that seeks to solve any inadequacies or other problems related to the Commodity Exchange Act or the work of the Commission.

It is my hope and belief that many of the issues raised by the CFTC rulemakings in the past 3 years that eventually became the subject of Congressional legislation have been resolved or adequately addressed in our final rules or through other relief granted by the agency. With or without additional direction from Congress through CFTC reauthorization, it is important that the agency and its staff continue to find ways to address problems that are still in need of a solution.

Second, the Commission's implementation of Title VII of Dodd-Frank is for the most part finished. We have almost 80 swap dealers now registered with the CFTC, clearing mandates in place for a broad swath of the swap market, and new reporting obligations for market participants. The Commission also just completed its cross-border guidance informing market participants and other regulators how the Commission's rules will be applied to activities and entities overseas.

Looking ahead through the lens of what already has been done, the Commission and all stakeholders will need to closely monitor and, if appropriate, address the inevitable challenges that will come with implementing the new regulatory framework under Dodd-Frank.

Third, while most of the Commission's work to implement Dodd-Frank is complete, there remain important rulemakings and administrative matters in the months ahead. Perhaps most importantly, the Commission, along with the Federal Reserve, the OCC, the FDIC, and the SEC, must finalize its rulemaking on the so-called Volcker Rule.

The agency also must undertake substituted compliance determinations under the recently finalized cross-border guidance. This will involve a review of swap-regulatory regimes in other nations to determine whether they are comparable and comprehensive or essentially identical to U.S. law.

The Commission also must finalize its rulemaking on capital and margin requirements for uncleared swaps and there are two very important rulemakings related to the international harmonization of risk management requirements on clearinghouses, which dovetails with the substituted compliance determinations.

Another critical rulemaking, albeit not directly related to Dodd-Frank, is the Commission's customer protection rule that seeks to improve risk management practices at futures commission merchants.

Finally, given that the U.S. has nearly delivered on its G20 commitments to derivatives reform and the European Union is close behind, all of us can spend more time focusing on the developing market structure for swaps on a more global scale. The Commission already has authorized new trading platforms for swaps and Europe is about to do the same. We anticipate that with these de-

velopments, many swaps will be executed on regulated and transparent marketplaces located both here and abroad, facilitating global liquidity formation and risk management.

Consistent with this result, I believe the Commission's cross-border guidance reversed a developing trend toward market and risk management fragmentation that would have been counterproductive to the goals of Dodd-Frank, as well as the G20 commitments.

But we all must wait and see to a greater degree what developments will take shape outside of the U.S. and Europe. Other jurisdictions that host a substantial market for swap activity are still working on their reforms and certainly will be informed by our work. All of us will need to monitor those developments closely with an eye toward how they could separate those jurisdictions from the fabric we, along with our European partners, stitched together in last week's accord.

In other words, the Commission must remain vigilant in monitoring, identifying, and addressing risk, and continually prioritize so we are focused on the greatest threats. Indeed, another threat identified by the Treasury Secretary 2 weeks ago must be part of this global monitoring: the cybersecurity threat. As marketplaces and systems continue to rely more and more on technology, the need to better understand and protect against cybersecurity threats increases. There are multiple task forces and coalitions formed of domestic and international partners that the Commission will need to work with to ensure success on this front.

Thank you again for inviting me today. I would be happy to answer any questions.

[The prepared statement of Mr. Wetjen follows:]

PREPARED STATEMENT OF HON. MARK P. WETJEN, COMMISSIONER, U.S. COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

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Thank you again for inviting me today. I would be happy to answer any questions from the panel.

The CHAIRMAN. Thanks, Mark. I appreciate that.

The chair would remind Members that they will be recognized for questioning in order of seniority for Members who were here at the start of the hearing. After that, Members will be recognized in order of arrival, and I appreciate Members' understanding.

And with that, I would like to recognize the Chairman of the full Committee, Mr. Lucas, for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman. I appreciate that, and I appreciate the efforts of yourself and the Ranking Member as we proceed through this process. And I want to thank both of the Commissioners for testifying today.

The topic of CFTC reauthorization is a very important one, and this is the Committee's second hearing on the issue. Tomorrow, we will continue the process and hear directly from end-users. I expect the Committee to move forward with CFTC reauthorization as the farm bill also progresses.

Now, a couple of issues confronting us; in light of the confusion surrounding the exemptive order and final guidance that has been circulated to regulate cross-border transactions, how can institutions be sure they are correctly interpreting these policies? And can either of you comment on whether the Commission will give some degree of deference to American firms as they implement the hundreds of pages of new guidelines, gentlemen?

Mr. O'MALIA. Thank you for the question, a very good question, and it is a challenge. So the guidance has been out less than a week and people are beginning to digest it and I am trying to understand and make sense of it and understand where their activities fall. It is complicated depending on your organizational structure, *et cetera*. I think we have to give the appropriate deference to people trying to comply with the rules. And this is not dissimilar from any of the other complex rulemakings, including the *swap dealer* definition. And so we have always had to have some latitude to provide people the cooperation and convenience to comply with the rules, and we have to respond to their questions as quickly as possible.

Mr. WETJEN. Thank you, Mr. Chairman, for the question. I agree with Commissioner O'Malia. I think what you might be referring to is a provision that was in the exemptive order that expired, that was not retained in the new exemptive order, and it had to do with basically a statement of fact as I see it, and that was that we expect good-faith compliance at the agency during this unusual time of implementation of our rules and initial compliance with our rules.

And so while the new exemptive order did not retain that provision, as I said, I believe it is a statement of fact. So we are going to have to continue working with all market participants. I am sure a number of questions will come up, some have already materialized in the last week or so and I am sure others will come up as well. And so we will just have to keep working with market participants in sorting out some of these issues.

Mr. LUCAS. Commissioner O'Malia, I was pretty troubled reading your testimony that the Commission staff may now be initiating enforcement actions outside of the Commission vote process. Is this a new change in policy or has it been done before?

Mr. O'MALIA. Thank you for the question. It is a relatively new change. The issue that I raised is that the Commission, under Dodd-Frank, has issued a number of broad omnibus orders to initiate oversight or undertake subpoena authority. Now, these broad authorities don't identify specific practices but they are seeking approval from the Commission to issue subpoenas over a scope of law that they believe they have concerns about.

Now, we have provided these omnibus orders in the past and they are generally time-limited, and I have had some concerns about that because the Commission's authority to approve the rule and to approve the initiation of an omnibus order and subpoena is

a fundamental part of the Commission's responsibility. It is not something that should be delegated to staff, and in fact, Commission Regulation 11.4 requires Commission action to issue these orders.

Now, the recent activity, there are two things that have occurred. One, they have asked for absent objection by the Commission, meaning that it is a staff action. When I asked our General Counsel if the Commission could overrule an absent objection circulation, he said no, it is not a Commission action. Therefore, it does not fall within our authority under 11.4 for the Commission to initiate these type of investigations.

So I believe this is kind of a slippery slope we are headed down and it is a concern of mine that we not delegate too much authority to staff, especially with the new authority under Dodd-Frank. I think there are a lot of areas here that are not explored. Think about the new manipulation authority. We have a new recklessness standard. We need to be thinking about these and how they will be interpreted by the market.

Mr. LUCAS. I absolutely agree and I suggest that whatever we have to do to preserve the check-and-balance system that Congress envisioned when it created the five-member Commission is absolutely necessary. The requirement for a vote on key actions should not be disregarded under some guise of efficient government, which is a paradox if I have ever heard of one.

I thank you, Mr. Chairman, and I yield back my seconds.

The CHAIRMAN. The gentleman yields back 2 seconds. Mr. Scott, 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman.

Let me start with you, Commissioner Wetjen. Do you have sufficient staff to accomplish the task that you all have been given?

Mr. WETJEN. Thank you, Congressman Scott, for that question. I believe the answer is no. As we all know and as we discussed in our opening statements, the responsibilities of our agency have increased dramatically in the past 3 years. We are overseeing a market that we had very, very little oversight over before. It is a massive market. There are, as I said in my opening statement, close to 80 registrants now registered as swap dealers. So there is no doubt our responsibilities have been magnified and we need the resources to do the job and to mete out these new responsibilities.

And here is a main reason for it. And it is especially true now that we are mostly finished with finalizing the rules but we are at the beginning stage of the implementation process. And the reason why we need resources, probably the most important reason in my mind is during this new phase of implementation—and we have already seen it; we have already talked about it this morning—a number of questions are going to continue to come up. Market participants are going to have multiple interpretive questions. They are going to need additional guidance from staff, in some cases additional guidance from the Commission as a whole, and we need staff to be able to provide that.

And the reason we need to do that is because, again, we have been in this process now 3 years. The markets need and deserve certainty, and the way that we provide certainty is by having the

staff in our building that can get answers to market participants as quickly as possible.

Mr. DAVID SCOTT of Georgia. And so how much funding do you need? Your appropriations authorization runs out, as I said, in about 9 weeks on September the 30th, so this is very important that we move expeditiously to get you the funding that you need. Would you tell us how much that is?

Mr. WETJEN. Well, the budget request was a pretty significant increase over our current budget, as you know, Mr. Scott. I think the request was around $305 million.

Mr. DAVID SCOTT of Georgia. And that would be about a 52 percent increase, is that correct?

Mr. WETJEN. I think that sounds right, yes. And here is how we came up with that number. You know, the Chairman obviously manages this process, but in terms of the rest of us who have to decide whether or not to support a big budget request, the division heads within the agency, they all make their case to us as to what they believe they need, and after going through that process and listening directly from them what their justification was for the request, I feel comfortable supporting the request. I thought it was justified.

Mr. DAVID SCOTT of Georgia. Very good. Just before I get to Mr. O'Malia, I would like to just make mention for the Committee that back in February, Chairman Gensler said, budget cuts have caused the CFTC to shelve some potential enforcement actions. This means cases that should have been investigated and/or prosecuted were passed over due to a lack of funds.

I think it is very important, Mr. Chairman, that we make sure the record is clear that this agency needs the funding that we are asking them to do a job, their workload has been overloaded, they have had burnout at staff, they have done a commendable job with the intelligence and the precision and the commitment and dedication. I think it is very important that we honor their request, going forward, for this 52 percent increase, and I for one, I think you will agree, will know that that is very important. I think I have one more minute here.

Commissioner O'Malia, could I get your opinion on, we just passed House Resolution 1256. And the two major parts of that were harmonization between you all and the SEC. I would like to ask you to comment very briefly on where that is, how that is coming along. And then the second part, the making sure that those nine major economies that we have to deal with have regimes that are equal to ours for enforcement.

Mr. O'MALIA. Well, that is a very important and timely question. The harmonization effort, we have struggled with, frankly. Our agency has put forward *cross-border* definitions that is not consistent with the SEC definition. We are on a different timeline and we have used a different process. They have used a regulation. We have relied on guidance. And I have some very serious concerns about relying on guidance in and of itself, and when I asked our General Counsel how do we bring enforcement under guidance, he said it does not have the force of law provided under regulation.

So I am frustrated with the lack of coordination between the SEC and the CFTC. I think it is almost comical that we would

have two agencies coming up with a different definition of a *U.S. person.* So that is problematic in and of itself.

The question about how we were going to find substituted compliance with regard to the other nine regulatory regimes is really what is important and what is the focus of the Commission's efforts right now. We passed an exemptive order that provides until end of December, right before Christmas, relief that will expire and we will be back in the same situation of being up against an artificial deadline. But in that time, between now and then, we have to determine and do an evaluation of all of these different jurisdictions for comparability and do they match with our regulatory regime. And that will be a tough situation and it is not easy because there are a lot of details we are going to have to go through. Our guidance does say we will consider it on an outcomes basis, but I am skeptical that that will really be applied in actuality when the staff goes through and does its evaluation. Harmonization is vital if we are going to make this work effectively, and we cannot unilaterally dictate our rules to the rest of the world.

Mr. DAVID SCOTT of Georgia. Thank you. And thank you, Mr. Chairman, for that extra minute.

The CHAIRMAN. All right. I recognize myself for 5 minutes.

Commissioner O'Malia, you mentioned in your testimony the cost-benefit issue and the ongoing controversy that we have had with the Commission during most of the Dodd-Frank era in terms of my dissatisfaction with the level of attention that was paid to that issue. Can you talk to us a little bit about with the bill that we have passed through the House, if you implemented it—and Mark, I would like you to weigh in on this, too—if we implemented that bill itself, would that put the Commission on a proper footing with respect to how it would have to analyze the impact that potential regulations had on those who are regulated and the compliance with that?

Mr. O'MALIA. I think that bill would be a vast improvement over the current standards we have under the CEA in 15(a). I think in the recent ICI case, the District Court found that the Commission, where defendants complained that our standard wasn't very high and the judge affirmed it, it was not a very high standard, and we do not have to do a quantitative and qualitative analysis necessity to justify the costs and the benefits. I think implementation and passage of the cost-benefit bill that you have sponsored in the House as passed would be a vast improvement for our Commission and would require us to do a much more rigorous evaluation of the rules.

The CHAIRMAN. Commissioner Wetjen, thoughts?

Mr. WETJEN. Thanks, Mr. Chairman. I just wanted to point out that Commissioner O'Malia has been a real leader at our agency on this topic. He has been very effective at keeping the agency and the agency staff focused on this provision.

In our statute—of course, I am referring to Section 15(a), which is current requirement that we take into account the costs and benefits of our provisions in a rulemaking. And I have to say since I have been at the Commission, it is almost 2 years now, I have seen a real commitment to 15(a) and to making sure that it is being implemented appropriately.

And Scott mentioned the ICI litigation. That is one view to take of the litigation, but what was more important to me from the litigation is the fact that both the District Court and Appellate Court found that we are again abiding by the current requirements of the Commodity Exchange Act with respect to Section 15(a). I am always happy to explore ways to improve. Mr. Chairman, you and I have had some initial discussions about that. I happy to continue those, but for now, it is important to point out that, at least in the time that I have been at the Commission, we have done, in my judgment, a satisfactory job on this front.

The CHAIRMAN. Well, I appreciate the perspective. I need to correct the record. The bill was only passed out of Committee with a voice vote. We still have yet to get across the Floor.

I guess one of the things that we are asking industry is to look at the effectiveness of the cost-benefit analysis that was done on many of the Dodd-Frank rules now that they have some perspective in actually having to implement and how much it is actually costing them *versus* what the Commission on the front end said it would. And so we will hopefully have a bit of empirical evidence to show that whatever was done—again, this is a prospective change; we are not going to go back and redo anything—but whatever impact the costs had on the regulation that that was chosen by the Commission in order to be put in place; were those costs rational at the time you were making your decision? And all of us make better decisions with better information, so we will hopefully have some empirical evidence on what the Commission thought it would cost to implement many of these regulations when you were doing it *versus* what the industry and the folks who are having to comply with those have actually had to invest in making that happen.

And I don't want to run over, but can you talk to us a bit about the pervasive use of no-action letters and just kind of walk us through mechanically how that happens? Is there a way to improve the process so either you need fewer of them or you can issue them in a more timely basis, and what impact does that actually have?

Mr. O'MALIA. I think no-action is an important tool for the Commission to provide a very selective, narrowly crafted relief to either a particular entity or for a certain activity. And we have relied on it heavily in the past. We have relied on it in the past to provide these narrow execeptions. Now, what we have done in moving our rules forward, we relied on it more heavily in order to provide relief from general time frames and timelines that are unachievable by the industry.

I think the poster child for the no-action relief was for the special entity relief for utility special entities. We called it temporary relief until the Commission reevaluates the rules. Well, in October it will be a full year. We have no intention of really going back to revisit that rule, which is the *swap dealer* definition. So I suspect we will not reopen that, so we have offered what fundamentally becomes indefinite relief. That in fact is a rulemaking. If you are changing the Commission's policies indefinitely, that turns out to be a rulemaking, and it did not have the benefit of APA notice and comment and cost-benefit analysis.

In that instance we really need to go back and really look at how we are going to use this no-action process. And in my testimony, I suggest this is an area for the Committee to really evaluate to understand what our policies and procedures are and how we are going to be using it.

The CHAIRMAN. Okay. Thank you, Scott. Mr. Vargas for 5 minutes.

Mr. VARGAS. Thank you, Mr. Chairman, for the opportunity to speak. And I also want to thank the witnesses here today. You have already testified a little bit about this and that is the budget request, and my understanding is that it is in fact a 15.25 percent increase above the current year. I would like to comment more specifically about the IT factor of this, and it doesn't matter who goes first, but I think that is an important factor. Mr. O'Malia, you are chomping at the bit. Why don't you go first?

Mr. O'MALIA. Well, I am because technology and the IT sector is really a passion of mine and I am very interested. And since arriving at the Commission I have really put a lot of focus and attention on it. And my frustration with it is that it is always kind of a second-tier issue for us. And despite the kind of promise of investing in technology and making IT a priority, consistently we underfund it, and for the past 2 or 3 years, we have always taken $10 million out of the technology budget and shifted it over to staffing needs.

And granted, there is a balancing act here but we are policing a 21st century market with 20th century surveillance tools. We need to do much more to invest in technology to really leverage our staffing needs. We could rely on less staffing if we are able to automate our surveillance tools.

And under Dodd-Frank we have an enormous task ahead of us. We have required that everybody report all of their trades and their data into a swap data repository. Our ability to look into that and evaluate and do the analysis on it is critically important if we are going to be an effective regulator. And then we have to link it back to the futures market. There are no shortcuts with this. This is not eyeshades and Excel spreadsheets. This is serious data crunching that we are going to need automation for it.

So I am very frustrated that we have not invested to our greatest capacity. One of the areas where we need to focus is actually developing a budget that selects good priorities, and one area that I have advocated for is a division-by-division analysis of what our needs for the next 5 years are for technology. This is something the Committee should ask for. Where do you want to be in 5 years as part of your reauthorization? Technology is a critical element, so how are we going to get there and what tools are we going to need to get there? After you have that evaluation, then you and I can make real serious decisions about funding levels and budget priorities. And until we develop that budget spend plan for you, we are in the dark.

Mr. VARGAS. Mr. Wetjen, would you care to comment on that or do you generally agree?

Mr. WETJEN. I do generally agree. This is another area where Commissioner O'Malia has been very vocal in his advocacy for additional resources to be targeted at IT investments at the agency. It is a very noncontroversial position for him to take. As I said in

my opening statement, participation in our markets are basically driven by technology and through technology, and so in order to keep up surveillance it is also going to have to rely heavily on it. There is always going to be an important component of human interface with the technology that is being deployed and used, but without a doubt I agree it is an area of improvement that we need to focus on at the agency.

Mr. VARGAS. I would like to ask one last question and I only have a minute and 40 seconds. My question would be this, and that is the issue that a lot of people ask. Is there overspeculation in the commodities derivatives market in the sense that you see these radical price swings and market uncertainty especially with issues of energy, gasoline. And I would like to know if this is market forces or you said you need serious data crunching, this technology. If we had this ability, do you think we could tell the American people that what you see in the cost of gasoline is in fact market prices and not some sort of speculation that is inappropriate? Because that is what Dodd-Frank and all of this is supposed to do. Does someone care to take a shot?

Mr. WETJEN. Thank you, Congressman. I think that certainly monitoring the markets we oversee for speculative activity is important. It is part of what we do now. I would like to point out that the Commission has a weekly surveillance meeting every Friday where we review and have the staff present any sorts of odd activity in the marketplace, any sorts of irregularities that they might be seeing. And it doesn't focus solely on energy commodities. It runs the whole range of asset classes.

First and foremost, that is what we need to do. We need to continue being very, very vigilant in regard to our surveillance activities. And Scott alluded to this. I just spoke about it as well. Additional technology investments should help on that score. But we have done a pretty decent job of trying to keep tabs on true irregularities and——

Mr. VARGAS. Thank you. My time has concluded here but I appreciate it. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The other Mr. Scott from Georgia, 5 minutes.

Mr. AUSTIN SCOTT of Georgia. Thank you, Mr. Chairman.

Commissioner Wetjen, Commissioner O'Malia spoke of the need to have better coordination with the SEC on just some basic definitions. Do you agree with him on that?

Mr. WETJEN. I appreciate the question, Mr. Congressman. There is a provision in Dodd-Frank in Title VII that requires us to coordinate. Even absent a specific mandate to do a joint rule, we still have this obligation under the statute to coordinate as best we can. I think Scott would agree that he and I don't always see everything that is going on at the agency because we are just one of five Commissioners, actually four at the moment. But I do think it is fair to say that there is a lot more going on behind the scenes than people realize. I think there are a lot of staff discussions taking place between the SEC and the CFTC. I think we could probably always do more.

But the one last thing I would add, Congressman, is that in the weeks leading up to the finalization of the guidance, I can assure

you I was having multiple conversations with SEC Commissioners, high-level SEC officials. I was having multiple conversations with members of the European Commission, conversations with other agencies within the Federal Government that had an interest in what we were doing with the guidance. So I felt pretty good about the level of engagement I was able to get with my counterparts at these different regulatory bodies.

Mr. AUSTIN SCOTT of Georgia. That kind of answered my next question as well, which was do you believe that the SEC shares that desire to have uniform definitions? And certainly, that makes it easier from a compliance standpoint for those that are being regulated, as well as from a regulatory standpoint. If we can't even get to the agreement on what the definition of a *U.S. person* is, then how do we get to the definition of what a *direct and significant impact on U.S. consumers* is?

And so that would lead to my next question, which is the Act says it shall not apply to swap activities that do not have a direct and significant connection with activities in, or effect on, commerce in the United States. The definition of *direct and significant,* can you give us that?

Mr. WETJEN. So the question was what I think the definition of a *direct and significant impact on U.S. commerce* is? Well, the words obviously are somewhat plain and in many ways speak for themselves, but I will tell you how I interpret it. To me, what it meant was when we designed our cross-border policy, we needed to ensure that the U.S. taxpayer was protected and the U.S. financial system was protected. The mandate was not to go too far in that effort, but at a minimum, we needed to be sure that those two objectives were accomplished. Through the other provisions of the policy we adopted through the guidance, that will be the effect of our policy once it is implemented and once market participants comply with it.

Mr. AUSTIN SCOTT of Georgia. Well, I know there was some discussion of latitude to comply with the new rules, but again, if we don't have a definition of what *direct and significant* is, then how can somebody who is being regulated comply with that rule? And I would hope that *direct and significant* is another term that you are able to get a uniform agreement with the SEC on because, I mean, look, simpler is better from the regulator standpoint and it is certainly better from the person who is trying to comply with the rules just to keep up with one definition instead of multiple.

But you do not have a feel for at what point the transactions are *de minimis* so that they would not be subject it to the new regulations?

Mr. WETJEN. I guess the first way I would answer that question is under our guidance, if there is an entity, even if it is offshore but it has the benefit of parental guarantee or if it is a foreign branch of a U.S. bank, in which case obviously it would be offshore as well, the guidance provides that those entities, if they do the requisite level of specified swap dealing activity, they would need to register as swap dealers. And the policy behind that is again by virtue of the parental guarantee or in the case of a foreign branch the legal structure of the bank, the risk will come back to the United States to the parent or to the home bank. And for that rea-

son the Commission decided that it was appropriate to ensure or to require registration so long as the requisite amount of activity was actually taking place.

Commissioner O'Malia referred to it earlier. We have this *de minimis* threshold and for now you have to deal more than $8 billion of swap dealing activity. In that event, you have to register but——

Mr. AUSTIN SCOTT of Georgia. Sorry to interrupt. I am down to about 5 seconds. I do hope that you will continue to get the uniform definitions with the SEC and our overseas regulators as well. It would just make it easier to regulate and for those other entities to comply with regulations. With that, I yield back.

The CHAIRMAN. The gentleman's time has expired. Mr. Maloney for 5 minutes.

Mr. MALONEY. Well, thank you very much. And I apologize for being absent for a moment. Thank you both for your service. Thank you for all the hard work that you have done. I think it is often overlooked just how much has been going on in the CFTC and I want to commend you both for that. And thank you for your appearance here today. My question to either of you, I would be interested to hear your views, what happens on December 21, with respect to the interpretive guidance and the exemptive order if the Europeans aren't ready? Do you expect the Europeans to be ready and, if not, what happens?

Mr. O'MALIA. Thank you for that question. I think it is a very important question because we faced an artificial deadline of July 12, 2 weeks ago, and we have created another artificial deadline. And this one is again backed up right against the holidays. Of course, everybody will be intently focused on fixing it, but at the same time, we don't give ourselves much leeway in terms of being able to resolve it if it goes over. We were forced into an artificial deadline that created some flawed policy. We took shortcuts with the Administrative Procedure Act—which shouldn't be done—with notice and comment. And I am very concerned that we will not have a process in place that will give careful evaluation to the substituted compliance regimes and make that determination and put in place a new regime to follow on to that.

At our open meeting 2 weeks ago, I asked the staff what is the process for the substituted compliance determination? When will we make it? What information will we have about different regimes and what are the recommendations of staff? The Chairman actually directed staff at that meeting to provide within 2 weeks, which will be this Friday, a process for the Commission to evaluate. I think this needs to be fully exposed to transparency, open meetings, allow for foreign entities to come defend their applications and talk to us, directly to the Commissioners, not through a staff no-action, not through sending e-mails or discussions that are not privy to all four of us, to have this open discussion and figure out where we have comparable rules and where we do not have comparable rules and then how are we going to solve for the differences. So I look forward to having the process unveiled to us by the staff and how they are going to make this determination so we can better figure out if we have enough time so we don't put ourselves in a situation like we had with July 12.

Mr. MALONEY. Mr. Wetjen.

Mr. WETJEN. Thank you, Congressman Maloney. I think the answer is that, in an ideal world by December 21 the CFTC staff will have made recommendations to the full Commission regarding those jurisdictions that have submitted applications for substituted compliance determinations; that is Canada, the European Union, Japan, Hong Kong, Australia, and Switzerland. And as Commissioner O'Malia has said, we will be making full Commission determinations as to whether substituted compliance should be allowed.

I can see that is a fairly abbreviated time frame but it is one that was based on judgments made about how to make sure the process would be undertaken expeditiously. The date was also informed by input from these other foreign jurisdictions. And in some cases they suggest dates in order to keep their own countries on task and focused on their own finacial reform efforts. And so that is the reason behind the date. It could turn out to be that it is overly aggressive but we will have to wait and see. But it is not a totally irrational date in other words.

Mr. MALONEY. Let me ask you with my remaining time just an open-ended question to both of you. I am very curious if you just pull the lens back with all that is going on with the reauthorization still out there and these other issues, what is the thing that keeps you up at night? What is your biggest risk?

Mr. O'MALIA. Some of our biggest risks are the lack of certainty in our rules. I think that is the biggest complicating factor. And while it keeps me up, I am quite certain it keeps every commercial end-user, financial entity out there that are trying to comply with our rules on a regular basis, trying to do their jobs and to meet the obligations of these rules. What is frustrating about a swap dealer rule is you have to look towards position limits rules potentially and clearing determinations and made available for trade determinations and figure out where you sit in the queue and all your responsibilities. It is extraordinarily complex, which means it makes it extraordinarily expensive to do your job.

We have four or five different *hedging* definitions depending on if you are trading as a swap dealer or you are not trading as a swap dealer, if you are trading on position limits or you are trading on a different entity. Four rules for hedging determinations is insane. What is wrong with one? Why can't we treat it consistently? And that is something that I would encourage you to consider because this is the basic premise of what is hedging. And I think that is a very important thing for the Commission and the Committee to look at.

Mr. WETJEN. I was going to respond by saying my 3 year old is what keeps me up most nights.

Mr. MALONEY. It doesn't change when they are 12, believe me.

Mr. WETJEN. Is that true? Well, I am sorry to learn that. I think the thing that I worry most about is another incident where, because of gaps or failures in oversight, there is a failed firm and customer funds are lost. I think we have done a very good job in many ways responding to that. We have a proposed rulemaking that we hope to finalize very, very soon. But there is always this fear that I have that we don't know what we don't know. And so while the reforms that have been recommended are going to be very, very

good ones, it would be best to feel like you are going to eliminate all risk as it relates to the loss of customer funds. And so if there is any one thing I would identify, it is that.

The other thing is what I mentioned in my statement, Mr. Congressman, there is this looming cybersecurity threat that people are trying to get their minds around more in recent years, and that is something that we are going to have to focus on more because there is pretty significant vulnerability for our markets to these threats. And then the other thing is how the patchwork of global regulatory reforms takes shape and whether there are any gaps there. Our agency has found that the European regime is essentially identical, so that is a terrific first step and that covers most of the swap activity around the globe. But there are some other jurisdictions where there is significant activity as well. It is not clear what is going to happen there.

The CHAIRMAN. The gentleman's time has expired.

Mr. MALONEY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. LaMalfa, 5 minutes.

Mr. LAMALFA. Thank you, Mr. Chairman.

For Commissioner O'Malia, first of all, thank you, gentlemen, for being here today. I had a little mini chuckle with Mr. Maloney's question asking what happens December 21 and if this was a year ago, we would be worried about the Mayan calendar. This year I hope it is a lot less of a worry. Anyway, we have been very attentive to the swap dealer situation and we wanted to cover again CFTC has had a $25 million special entity subthreshold which needs to be fixed as it relates to public power utilities. Even though also the CFTC has provided a no-action letter increasing the subthreshold for certain transactions to $800 million, but the effect has been still to limit the pool of counterparties with which public power utilities can enter operations-related swaps, in turn, concentrating the risk to fewer market participants, so fewer participants. Because of these concerns, as also expressed by public utilities in my own district and throughout the whole country, myself and three of my colleagues, Mr. Denham, Mr. Costa, and Mr. Garamendi, as well as many other cosponsors, we introduced H.R. 1038, the Public Power Risk Management Act. Also Mr. Luetkemeyer, who sits on the House Banking Committee, was an original cosponsor as well.

The bill's purpose is to put public power utilities back on an even playing field with the other utilities in hedging their risks, this by exempting the operation and related swaps from their $25 million low subthreshold but giving them the same power to the general $8 billion threshold. So our Act, our bill was approved by this Committee unanimously—thanking the Members—as well as passed on the House Floor by 423 to 0 on June 12.

First, Mr. O'Malia, do you think this is the right approach that we have taken so far since this is maybe the first chance to talk to you about it? And second, is this an approach the CFTC would like to emulate itself and would it take place anytime soon? Or does the Congress need to move forward full speed ahead with this bill that we have already moved out of the House?

Mr. O'MALIA. That is a great question and a great issue. I fully support your legislation so thank you for that. And I hope the Sen-

ate will pass it so we can achieve the reform that I think is appropriate. I think this issue in and of itself—and here is the staff no-action letter right here. It says, "temporary relief." Temporary is only based on the fact that it promises that the Commission is going to review this and make changes. I don't see that happening anytime soon, if at all. So——

Mr. LAMALFA. Aspirin provides temporary relief. We need something more certain.

Mr. O'MALIA. I would agree with that. And it really goes into saying that the reason we provided the relief is because these entities, and the utilities are more sophisticated than the general special entity for one, and second, that there is a concern that at the $25 million, which is the same concern we have at the $800 million, that we have provided the relief to because you do not have counterparties for these energy companies that are trading in regional markets. And we lay out in our first justification for providing the relief that there are not adequate counterparties and therefore they are left to and still hostage to Wall Street banks.

Mr. LAMALFA. Let me jump to the second line here on this question here. So have any entities registered with CFTC as a swap dealer for having exceeded the $25 million subthreshold? Has anybody even taken part in that?

Mr. O'MALIA. Not that I am aware of.

Mr. LAMALFA. Yes. Yes.

Mr. O'MALIA. Nor at the $800 million that I am aware of.

Mr. LAMALFA. So do you think anymore will be coming into play under this $25 million rather than the $8 billion threshold?

Mr. O'MALIA. I don't know. I would go back to the staff and try to provide you some information——

Mr. LAMALFA. Well, if you had to prognosticate how things have been going on that and what do you think would happen?

Mr. O'MALIA. I doubt it. I think they are fleeing this market to avoid this very issue of becoming registered as a swap dealer for trading with a special entity.

Mr. LAMALFA. So the effects are on public power then that means less options for people that are public power users?

Mr. O'MALIA. That is correct.

Mr. LAMALFA. All right. Quickly, I will try to get to a final line here. We were talking about technology a little bit ago, too. Does CFTC currently have the necessary technology to monitor massive amounts? It sounded like no but at the beginning of the year, press reports indicated that an academic data sharing program run by the former Chief Economist may have resulted in proprietary data being disclosed in published academic papers. So with all this going on with NSA and other issues out there, we have very grave concerns of how are people's data being treated and what is the security of that? Please answer briefly on that.

Mr. O'MALIA. We have an IG investigation ongoing right now to uncover what happened and what went missing, but it is critical that we have policies and procedures, especially with regard to our markets as well as the international coordination to make sure that we protect all market data.

Mr. LAMALFA. Perhaps maybe too much data is being retrieved that can't possibly be managed. I will yield back. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. Mrs. Negrete McLeod, 5 minutes. No questions? Mr. Neugebauer, you are it. No questions? Mrs. Noem for 5 minutes.

Mrs. NOEM. Thank you, Mr. Chairman. I want to thank both the Commissioners for coming today. I wanted to thank you for your clarification on the hedging definitions because that has been a burr under our saddle for a while. And I am curious, that is what I understand to be under the Commission's authority to come up with the uniformity in those definitions. Are you taking action in that manner?

Mr. O'MALIA. Not in the manner and process that I am satisfied with.

Mrs. NOEM. Okay. Well, if we on this Committee can be helpful on that, that would certainly be a priority for me.

Do you have a secure method that you both believe in on protecting integrity of consumer and customer funds?

Mr. O'MALIA. One of the important things that we were made aware of following the bankruptcy of both Peregrine and MF Global was there was not a technology solution in place that would surveil on a daily basis what the status of customer funds was where they were and how they were being treated. We used the Technology Advisory Committee to respond immediately to that and we actually tasked the industry to come up with an industry-led and industry-funded solution. It didn't require a rulemaking. No taxpayer dollars had been expended for this.

But the industry quickly responded, and as of January this year, they have integrated a technology solution to double-check the accounts held at an FCM and double-check them against the custodian bank. And they have automated thresholds so that any deviation from that specific threshold will send a red flag.

So we will know when and if customer funds are being moved unexpectedly or illegally, and then we will be able to respond to that more quickly. That was not in place. It is in place today and we are continuing to build that out to include not only the FCM and the custodian bank but also carrying brokers and CCPs, the clearinghouses. So we will have an electronic net that can really identify when and if customer funds are moving.

We have also made some changes in our rules that we call the Corzine rule, for example, that requires the CEO to sign off on any time they move a certain amount of money, which is a very important reform. And we will be addressing the proposed customer protection reforms coming up regarding FCM management. And we haven't seen that final rule yet so we will wait on that.

Mrs. NOEM. Okay. Commissioner Wetjen, did you have anything to add to that? Do you think it is an adequate safety net out there and available technology-wise?

Mr. WETJEN. Well, I appreciate the question. As Commissioner O'Malia has said, a lot of changes have been made already on the part of the industry, and some of those new practices are going to be reflected in our customer protection rule once it is finalized. The

system and the safeguards have improved even without our finalization of the customer protection rule.

The one other thing we did right after I joined the Commission was a rulemaking that limited the types of risky investments that FCMs could invest in or could invest customer funds in. And so I thought that was an appropriate reform at the time. We do have one rule that has actually been finalized in response to some of the shortcomings in our previous regulatory structure. We need to get the rest of the way by finalizing the customer protections rule. As I said earlier in response to Congressman Maloney's question, once we finalize the rule, we will be in pretty good shape, but I would continue to worry that we don't know what we don't know, and so we will just have to continue monitoring the practices of the FCMs. That is going to be much easier to do with some of the new requirements under the final rulemaking, first and foremost, the daily reporting of balances to the SRO and to the Commission. I think that will be very important.

Mrs. NOEM. On another topic, is an insurance product a viable option for customers of futures trading?

Mr. WETJEN. That is a proposal that has been recommended by some. I think it is certainly worthy of consideration and exploration. One of the things we have heard from some is that the folks need to get a handle on what the expense of providing the insurance would be. One of the trade associations has undertaken a study on that front and so it would be important to understand what the costs would be. And it would be important because what we don't want to do is somehow saddle the FCMs with additional cost in a way that makes it more difficult for those who actually need to use our markets to hedge. We don't want to make it prohibitively expensive for them. So that would be counterproductive. That would be the issue to watch for when examining whether an insurance program has any viability.

Mr. O'MALIA. We want to make sure that we instill the right corporate culture in the management of not only the FCM but sometimes the larger entity, the family parent, and making sure that the CEO and the financial officers all have customer interests first and foremost in mind. And I know one of the concerns with the insurance fund is that, don't worry about it; it is insured. We want corporate cultures to make sure that they protect customers, not rely on an insurance fund as a backup strategy. So I look forward to reviewing the study on the customer protection issue.

I also want to pursue, and I put in my testimony, different bankruptcy reforms that would really improve the customer's chances of being fully refunded if there is ever a bankruptcy or a hole in the funds, to take that all the way up through the corporate structure and really make management totally accountable for customer protection.

Mrs. NOEM. I appreciate that. Thank you. With that, Mr. Chairman, I yield back.

The CHAIRMAN. The gentlelady yields back. Mr. Hudson for 5 minutes.

Mr. HUDSON. Thank you, Mr. Chairman.

Commissioner O'Malia, I am trying to understand the CFTC's final rulemaking on the *de minimis* level of swap dealing. Am I cor-

rect in reading that the level is set to automatically drop over 60 percent in 5 years without any public notice or comment?

Mr. O'MALIA. Correct.

Mr. HUDSON. Would you agree that such a drastic change should warrant some time for public comment?

Mr. O'MALIA. That is a frustration. We have provided for a number of automatic changes. Block rules, for example, required for swaps automatically rises from 50 percent to 67 percent. I proposed an amendment that, at the least, the Commission should evaluate and look at the data before we make any decision. My frustration lies with the *de minimis* rule as well. Making these automatic changes totally devoid of any data makes no sense to me.

Mr. HUDSON. Well, how exactly does the CFTC plan to evaluate what the *de minimis* level ought to be in 5 years? I mean what is the process there?

Mr. O'MALIA. Well, there is no requirement obviously. The swap dealer rule is an automatic change. Mind you, the SEC, even though we are supposed to do a joint rulemaking, they did not have an automatic reduction in their standard.

You know, we are going to benefit from having all of the reported swap data repository. It is really incumbent upon the Commission to aggregate, understand, and analyze that data, make its findings, and then make decisions based on that. To skip that step doesn't make sense to me.

Mr. HUDSON. Well, and my understanding is based on notional value, but that may work for interest rate swaps, but my concern is the commodities markets, the rising energy prices could push entities over the threshold without a needed change in their trading. In fact, the entities might be forced to limit trading when faced with rising prices, reducing liquidity at exactly the wrong time. And is the Commission even taking that into consideration?

Mr. O'MALIA. Not under this rule it hasn't. Those are very important questions and concerns you raise. One of the real frustrations with the swap dealer rule is the four-part test that provides for what is swap dealing, in that the Commission did not define it, and we use the facts and circumstances test. So there is a lot of uncertainty as to whether end-users fall within the dealing definition.

Congress gave us the tools in section 1a(49)(C) of the Act to provide for an exemption for people who are not doing swap dealing as a part of their regular business. We completely ignored that and did not provide that coverage to end-users. So they are left with this *de minimis* solution as their only protection against being a swap dealer, and that is unfortunate, especially in light of the fact that the number drops from $8 billion to $3 billion and all of a sudden what was acceptable the day before could be found to be dealing the next day and many people have to register. So we have some time, obviously, before that so I hope the Commission will revisit it. It ought to revisit the special entity threshold. So there are a couple of reasons why we ought to reopen the *swap dealer* definition.

Mr. HUDSON. I thank you for that. And I guess building on what my colleague Mr. LaMalfa was talking about assuming the $800 million *de minimis* threshold actually reduced the number of parties the special entity may deal with, I mean, what regulatory ben-

efit is gained by this limitation on a special entity's ability to offset risk? And I will open it up to both of you, Mr. O'Malia, if you want to start.

Mr. O'MALIA. Well, the promise we made in offering the exemptive relief or the staff no-action was because at $25 million they weren't going to have enough counterparties. We raised it to $800 million, or the staff raised it to $800 million, they are still in the same problem. So we just provided a solution that doesn't solve the problem. So either that number has to go up and I don't know why we would want to treat them any differently than any other end-user for the purposes of a *de minimis* or Congress ought to step in and change it.

Mr. HUDSON. Mr. Wetjen, if you would like to respond, I have a minute left.

Mr. WETJEN. Sure, Congressman. Thanks for the question. I think that experience has shown us that with regard to the special entity *de minimis*, the level was set too low. The level that it is currently set at through the no-action letter, $800 million, as you alluded to, was the number suggested by market participants. I think it is informed by the petition that was submitted by one of the trade groups that is seeking to change the definition. And the no-action letter does hinge on Commission action on that petition, so in the meanwhile the no-action is effective.

I am not aware of any particular reason why the no-action letter has not done the job in terms of providing the relief sought. There obviously is a difference between no-action relief and a full Commission exemptive order or a Commission rulemaking. I certainly can see that point. But I am not aware that there is something peculiar about the fact that the relief has come through a no-action letter, that it hasn't provided the relief sought. And so I would have to learn more from the market participants who sought the relief to understand that better.

But as far as where the level is set, again, as informed by those impacted by the *de minimis* threshold in the first place, so if it needs to be a different number, we need to be open to that. It was set based on information that was provided to us.

And I agree with Commissioner O'Malia. Whenever we can, we should always take Commission action. And again, in this instance, no-action relief was provided because it was somewhat targeted in the sense that it was specific to a subset of these special entity groups. But I agree. If it can have the effect long-term of effectuating an entirely different policy than what was in the swap dealer rule, that is something the Commission should reexamine.

Mr. HUDSON. Well, our time has expired. I appreciate it. Mr. Chairman, we definitely need to provide more certainty than a no-action letter, and so I hope this Committee will work towards that working with the Commission. And I yield back.

The CHAIRMAN. The gentleman's time expired previously but he yields back anyway. Mrs. Hartzler for 5 minutes.

Mrs. HARTZLER. Thank you, Mr. Chairman, and thank you, gentlemen.

I am hearing a lot about an issue that directly impacts the folks back home with some of the rules that are being proposed. We have heard from farmers and ranchers and small- to medium-sized fu-

tures commission merchants strongly opposing the CFTC's proposed rules that were supposedly designed to improve customer protections. Instead, many of them say the new proposals would profoundly increase their costs and potentially threaten their existence. If the proposed rules are implemented as currently drafted, FCMs must hold enough of their own funds to cover all customer positions at all times of the day, in addition to the farmers and ranchers now having to meet just a 1 day margin call. So if this happens, what will happen to the agriculture segment of the futures markets both from the FCM and from the customer standpoint?

Mr. WETJEN. Congresswoman, I appreciate the question. You are referring to the residual interest provision in our customer protection rulemaking that has not been finalized, and it is true that the proposal would have had an effect consistent with what you said. The staff is preparing a draft and will recommend a different approach on this particular issue as I understand it, based on our internal dialogues.

I think, again, we have to find a balance. You know, the statute does require that customer seg funds should be protected at all times and shouldn't be covered by some other customer's funds. And so that is an important principle we need to have reflected in our rulemakings. But by the same token, what was originally proposed is such a dramatic change from the current practice. We started to hear the same concern that you just raised, which was that many FCMs wouldn't be able to handle that additional expense and might very well go out of business, and these tend to be the ones that provide services to the hedgers back in places like Iowa where I am from and back in your district. So I am eager to take a look at what the staff recommends and to ensure that it finds the right balance.

Mr. O'MALIA. I share your concerns. I think I share the same concerns that Commissioner Wetjen does. It is a balance and we have to be very careful as we do not want to put these FCMs in a position that they can't serve their customers and the customers can't afford to hedge their risk. So I haven't received the same staff briefing and with the commitment that they are coming up with a different approach, so I will carefully evaluate it when it comes before the Commission. But this is a top priority for that rule so thank you for the question.

Mrs. HARTZLER. You bet. I am from Missouri in a mainly rural district and so this is important to us so I am just curious about the draft. Now, was it dealing with the FCM's requirements or was it dealing with the farmers' 1-day margin or both?

Mr. O'MALIA. Well, the rule changes the way FCMs hold the money and therefore the commitments—it changes the interpretation of what we had historically been relying on in the past and that would change how much farmers and ranchers would have to put up to meet that demand and it reduces the FCM's flexibility to extend the credit to their customers.

Mr. WETJEN. Yes, I would agree with that and say it just a little bit differently. You know, where we land will have to be informed by how quickly the FCM can actually collect additional margin from a customer and how quickly margin is provided by some users

is different from how much time it takes with others. And again, we will have to make sure the balance is struck in the final rule.

Mrs. HARTZLER. I am encouraged to hear that you are listening and trying to wait because the average farmer relies on their local FCM, and I would hate to see the rule so onerous that it puts them out of business or makes it too difficult for the local farmer to be able to hedge their risk because that is a very big part of their marketing plan. So thank you for your response and I yield back.

The CHAIRMAN. The gentlelady yields back. I will recognize myself. We will have a second round since we have a little bit of time left to do that.

Playing off of what we were just talking about, the Agricultural Advisory Committee meets tomorrow for the first time in 2½ years, a pretty tumultuous time during the Commission's existence, and I am concerned that the ag community not having had access to the Commission directly, during that time frame, has missed an opportunity to hear some of these concerns that Vicki and I hear from the folks.

So what is your expectation as to what the Agricultural Advisory Committee can do with respect to advising the Commission on the impact that the proposed rulemaking will have? Mark, do you want to start off?

Mr. WETJEN. Mr. Chairman, oftentimes, we might hear more often from certain segments of the marketplace than others, and so the main importance of this Agriculture Advisory Committee is to make sure that the Commission is being informed by the perspective of that community when we adopt policies at the agency. I think through our rulemakings under Dodd-Frank, for example, we have received literally tens of thousands of comment letters, and a lot of those have come from groups representing the ag interests. So I do feel like we have received a lot of input, valuable input from that community, but this would be a good forum to make sure that we are especially focused on their interests.

Mr. O'MALIA. Obviously, the Advisory Committee has the potential to be a very useful tool for the Commission to discuss issues that are not immediately before it and think about different issues affecting that industry, so I remain optimistic. We have used the Technology Advisory Committee quite effectively to talk about customer protection, talk about high-frequency trading, talk about risk mitigation tools. So they are important tools. I just hope that this is as effective as that.

The CHAIRMAN. Speaking of that advice, it seems to me that the self-regulatory agencies who drove the daily bank confirmation process really got to the heart of the customer protection issue. Will that effort be reflected in the final rulemaking with respect to customer protection? Because if in fact your new rule drives greater customer balances at the FCM, aren't you exposing them to greater risks for loss of those dollars? How much is enough? I am hopeful that you will be able to fold all that in.

You both have spoken about how data collection plays a great role in the regulatory scheme and how that should be able to ferret out all kinds of stuff. Can you talk to us about why that didn't work in the J.P. Morgan "London Whale" deal from last summer

and why we have not been able to ferret that out at this point? Why did the data collection oversight potential not work?

Mr. O'MALIA. Data requires very rigorous and disciplined rules and kinds of policies. We have to be very prescriptive with requiring what data to be reported and when, and we weren't adequately prescriptive. Ironically, I am talking about how the Commission failed to be prescriptive, which is generally not the case with most of its rules. But in terms of data, it is a very granular requirement. You have to be very specific about how people report. Right now, we are not getting the consistency and uniformity that allows us to do the essential aggregation. If you can't line up the columns and you are not looking at the same data from the same people consistently, you won't get the right answers.

The CHAIRMAN. Well, doesn't that strike to the heart of most of what we are trying to do? Isn't that why we want all of this data collected through swap data repositories throughout the system; in order to be able to "see" where the bad actor is, and where the potential systemic risks to the financial system would lie? Are we no closer to making that happen?

Mr. O'MALIA. Well, we are making marginal progress but we are making steady progress, and we have convened a working group to really address this. And we are going back to first-order fundamentals to make sure that we work with the SDRs to identify this.

The other thing that is causing some problems with the data is actually the no-action process. When there is a gap in the data when somebody doesn't have to report for an entity or an activity that we have exempted, we won't be able to see that in the data.

The CHAIRMAN. Scott, with a relook at data collection requirements, will you have the potential to shed certain data you have been collecting in the past? Is it useful as you look at what you should be collecting in order to monitor the market?

Mr. O'MALIA. Well, we have taken a more prioritized approach. I still think we have a "we want it all, we want it now" attitude. But we are beginning to figure out that in order to swallow this issue, we are going to have to take it in bites. And we are starting to focus on getting elements right and building from there. But it is going to take a very long time—

The CHAIRMAN. Right.

Mr. O'MALIA.—to get this completely correct.

The CHAIRMAN. Mr. Scott, for an additional 5 minutes?

Mr. DAVID SCOTT of Georgia. Yes, thank you very much, Mr. Chairman.

Let me go back to my line of questioning because, after all, one of the major purposes of this hearing is for the reauthorization and your budget and appropriations. I want to follow up on the House Appropriations Committee reported an appropriation bill that reduces your funding for the CFTC by more than $10 million, below what we talked about earlier that you needed. Chairman Gensler was at that meeting and he testified. Mr. O'Malia, you were there as well, that even at current spending levels, that sequestration, that the CFTC would likely face furloughs, would very likely face reductions. And all that we talked about here at this meeting shows this increased load. So do you believe that this cut by the

Appropriations Committee is justified, and if so, which areas of the CFTC would you assign for furloughs?

Mr. O'MALIA. That is a very good question and it is a difficult one obviously because it strikes at the heart of kind of how we function. But the House level is where we are today and so while it is off of the 2013 appropriated level, it is at our current operating level of the sequestration. Now, we had the opportunity to use carryover balances. The Appropriations Committee was kind to give us 2 year money, which is essential, because that gives us some flexibility to husband resources as necessary to take and work through some of the difficult times. We were able to use a $6 million carryover balance this year alone to make sure that we did not have furloughs or layoffs at all. So we have yet been unaffected, but as time goes by, we may not have those carryover balances. We need to be very prudent with the management of our funds to make sure and protect our staff resources that we have today and not get into a position that we have furloughs in the future.

I had to dissent against a spend plan recently that would set that out, and in that document it did say that there is a chance that we would have some furloughs as a result of the budget.

Mr. DAVID SCOTT of Georgia. Going forward, in Europe in which you will be playing a far more intricate role, over in Europe there is talk about what they refer to as transaction taxes you may be familiar with. And some here in the United States, in view of these budget shortfalls, if you are not able to get the money that you need, have called for some kind of user fee or transaction fee to help finance the Commission's activities. What are your thoughts on that proposal and would they be any different at all from what Europe is offering? And quite honestly, should we go that way? I mean we are the leader here of the world. I value that. I think it is very important for us to sustain that. So I am concerned very much about your funding capacity. What would it mean if you are forced to have to go the way that these Europeans are talking about when it comes to transaction fees if we here in Congress don't give you the level of money you need?

Mr. O'MALIA. I think that is a great question. I think it is a very contested issue in Europe right now, as you correctly point out. It is very controversial. This year in the President's budget, OMB proposed a fee to be collected but it had no specifics as to how the fee would be assessed on our industry to recover these costs. I believe it says it is a full recovery of cost but I know OMB has not provided it to you in terms of requesting authorization to impose a fee. So they proposed a budget. It did not assume it in its baseline but it did talk about their desire to have one. You should receive that information. I have not seen information. I don't know how they were going to propose to collect this information or the funds. I don't know who it is going to be assessed on, and I would want to make sure that we understand what the ramifications of this are before we implement it and I don't have a position on it because I don't know what the proposal says.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. O'MALIA. We do rely to some extent, a very small amount, on the National Futures Association. They recover cost through their member registrations that are under our jurisdiction and they

provide a very valuable resource to the Commission. Their challenge has been to take taxing a futures trade *versus* a swaps trade but they handle that at 2¢ per side. It amounts to roughly 20 percent of the futures trades due to several exemptions in there, and then swap dealers are assessed a membership fee and the largest members pay $1 million, the smallest members pay as low as $150,000. So there is a range and we are using that. And members actually receive direct benefit from that. They receive the recovery of those costs in those services.

Mr. DAVID SCOTT of Georgia. Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Costa, 5 minutes.

Mr. COSTA. Thank you very much, Mr. Chairman.

This hearing today of which I missed the earlier part of it, but it is the continuation of other hearings that we have had, and the overall descriptive for me is that this continues to be a work in progress as we deal with the implementation of the efforts that are assigned under your responsibility.

Tell me, as you look down the road here over the next 5 years, what your expectations are in terms of the implementation and the regulatory process under the most optimistic scenario and what are your greatest fears under a most difficult 5 year journey in terms of what you wake up in the middle the night wondering, under what set of scenarios, *i.e.,* a repeat of the 2008 crash and how you might respond?

Mr. WETJEN. Congressman, I appreciate the question. First, I would answer by saying we do have a little bit of work left to do, as you know.

Mr. COSTA. That is my description, a work in progress.

Mr. WETJEN. I think one of the key areas of focus for the agency will be on these substituted compliance determinations where we take a look at regulatory regimes in other nations and determine whether they are comparable and comprehensive or essentially identical.

Mr. COSTA. To that end, are you working with our European allies?

Mr. WETJEN. Yes, in fact, certain determinations have effectively been made with regard to Europe. There was an agreement struck 2 weeks ago reflecting that. But the key will be looking at some of these other jurisdictions like Australia, Switzerland, Hong Kong, Japan. And then some of the other jurisdictions where——

Mr. COSTA. Do you believe the transparency is there with those other countries?

Mr. WETJEN. I am sorry?

Mr. COSTA. Do you believe the transparency is there with those other countries?

Mr. WETJEN. Well, the ones I mentioned, those are the ones that we expect to find to be closest.

Mr. COSTA. All right.

Mr. WETJEN. But again, there is swap activity taking place outside of those jurisdictions as well.

Mr. COSTA. Clearly.

Mr. WETJEN. And so we have taken an approach in our guidance to deal with those other jurisdictions, but we need to make sure

that we are collecting data and understanding what is happening in those jurisdictions as well. So that is probably the one area of focus for the Commission over the next 3 to 5 years in addition to just finishing the other remaining rulemakings under Title VII.

Mr. O'MALIA. I think the way Commissioner Wetjen answered, over the next 5 years, that will be the substituted compliance determinations, and coordination internationally will be paramount, and we are going to spend a lot more time dealing internationally to make sure that we have good rules that harmonize our rules and don't create a competitive imbalance. And one of the areas we need to be very focused on is in the transaction space. Our requirements for rules——

Mr. COSTA. And the transaction space, is that where you think you have to monitor in a way to not create a competitive disadvantage?

Mr. O'MALIA. Well, I don't know at this point. I think that is where we have probably the greatest differences in regulatory structures internationally. That is an area where trades can move easiest internationally. They can move trades to different platforms——

Mr. COSTA. Obviously the clearinghouses in Europe——

Mr. O'MALIA. I think we have very close comparability in terms of clearinghouses and recognizing the European clearinghouses, Asian clearinghouses, we are much closer in those regard. We have done a lot of work through IOSCO, and the international regulatory and Prudential Regulators have ensured that we do have systemically relevant entities that are going to be closely harmonized. The transaction space is going to be a little more Wild West and there is going to be a variety of different trading venues, platforms, and requirements, and that is going to be something that we need to focus on.

Mr. COSTA. With that thought in mind, I am going to give you the proverbial softball down the middle of the plate. So what do you think is the appropriate role for oversight for the Congress as you are trying to do your job?

Mr. O'MALIA. I would encourage careful and immediate oversight actually and really bring closer evaluation to how our rules are being implemented. I think you can start with some of the definitional rules, certainly entity rules like the *swap dealer* definition. We have had a lot of discussion about how our end-users are faring under this. There are some real examples of how this is making a lot of entities' life a challenge, hedging definitions, *et cetera,* that I raised earlier.

And I also think that Congress should really focus on expanding and changing some of the bankruptcy rules to really help in terms of protecting customer funds.

Mr. COSTA. Thank you. My time has expired.

The CHAIRMAN. The gentleman yields back. Mr. LaMalfa for 5 minutes.

Mr. LAMALFA. Thank you again, Mr. Chairman.

I wanted to come back to the no-action letters and some of the frustration among market participants about how they come about and their timing, *et cetera,* as we talked about earlier a little bit. We can come at the 11th hour while people are tracking maybe two

entirely different tracks anticipating scenarios with or without one. Could you explain, please, how the Commission standards work for issuing a no-action letter and who determines what entity or activity might receive such relief and whether or not the Commission itself is the one that votes on approving its issuance?

Mr. O'MALIA. Well, the no-action process, since I have been here has been an evolving one. I think historically the Commission has had a greater say and there has been some sort of—they would circulate the no-action relief, which is really—generally, an entity petitions the Commission and says we have a unique situation. We would like some very narrow relief. And we have used that over the years to provide that narrow relief to specific entities. And the staff will evaluate it and make its recommendation and then provide the no-action letter, circulate it to the Commission for review, but as we now know, that is not a Commission action and it is a staff action. So the Commission does not have a vote on that.

And therefore, it is a challenge because if you use it broadly—and we have used it and abused it frankly in kind of covering some of our faults in Dodd-Frank rulemaking, and if you use it indefinitely, it becomes a *de facto* rulemaking, which is certainly the purview of the Commission, and they are now substituting staff decisions for Commission decisions without the benefit of notice and comment, without having it be put in the *Federal Register* for everybody to review. It is a letter sent and it just generally appears on our website. And it is not added to the *Code of Federal Regulations* that we have so you can't go to one spot to figure out if you are in compliance or not because you have to check our website to see if there is any no-action relief on it.

Mr. LAMALFA. How many no-action letters do you think over the last year have been issued, do you think?

Mr. O'MALIA. I think in relation to Dodd-Frank, I tried counting them and we are a little over 100, and 24 of those, it is my understanding, we have provided indefinite relief meaning unlimited or permanent.

Mr. LAMALFA. And so you mentioned, too, it is kind of *de facto* for Commission rulemaking. What would be a better system for replacing that so that the Commission actually is doing the rulemaking instead of this gray zone we have, this really unpredictable situation you have, especially 11th hour decisions? How can we make that better?

Mr. O'MALIA. Well, and certainly no-action relief is a vital tool for us to provide that targeted relief, and we should use it for specific entities and on a limited basis. When we have an issue where we are considering permanent indefinite relief or something like that, then the Commission should revisit the rule. We should open up the rule and say we have an issue here that needs to be corrected, go through the proper process to make those rule changes. And we are beginning to rack up a few proposals where it is now appropriate to come back and reevaluate the rule. If I had a nickel for every time we have said at an open meeting we are going to come back and fix these rules if they are broken, I would be a rich man because we have always committed to that, yet we have never done it. And that is my frustration——

Mr. LAMALFA. You are probably starting to build a pattern of very often requests for a particular type of relief, right? So this would be a rule that you might put at the top of the list to come back on?

Mr. O'MALIA. The issue is that special entity issue. The headline of that no-action relief is temporary relief. What is temporary about it? It says the Commission is reviewing the petition. Nothing is happening at the Commission to review that petition. I don't see any action happening to fix the rule to fix this problem. And the no-action solution has turned into a no-fix of the problem, and that doesn't make sense to me either.

Mr. LAMALFA. Does Congress need to have a greater role, kind of dovetailing what Mr. Costa was asking, in oversight or even legislatively?

Mr. O'MALIA. You have the exact same role you did when Dodd-Frank was formed. You don't need any additional authority but I would suggest to you if we are not going to fix it, you should.

Mr. LAMALFA. Yes. Thank you. I yield back.

The CHAIRMAN. The gentleman yields back.

I brought up the issue a while ago of self-regulatory organizations. Is there a way for the Commission to offload some of its responsibility? Given the budgetary concerns that my colleagues have talked about, could some of that regulation be delegated to the SROs with the Commission then maintaining a role of supervising that or making sure the SROs did it correctly?

Mr. O'MALIA. This goes directly to Mr. Scott's concerns about budgeting. We do have a useful tool, as we talked about. The NFA, for example, charges its participants. Its budget is $74 million in 2014, so it is viable to do a lot of the registration responsibilities. They are going to play a vital role in our self-regulation. These are the swap execution facilities, these transactions. They are testing, reviewing the order book, and looking at all of the SEFs for compliance to make sure that they do their market surveillance tool, great opportunity to leverage our resources with that. And they have been a great resource for us in the past.

The swap dealer rule in and of itself—so far the NFA has received 168,000 pages of swap dealer submissions. It makes no sense to me for them to go through all of the swap dealer rules and all of these 168,000 pages of submissions and then have the Commission do the exact same review. We need to work together. We need to do a sampling. We need to figure out what their responsibilities and our responsibilities are because we certainly can't afford to do both.

The CHAIRMAN. You could see an opportunity for the SRO to do it first and then you come back in and pick the ones that present the most risks, or some sort of random deal and go through that. Depending on what you discover there, go with what the SRO did or go further, rather than a duplicative effort, isn't that a better way to go?

Mr. O'MALIA. I fully support that concept and we really need to figure out how we are going to leverage that as a tool, not duplicate it.

The CHAIRMAN. Yes. I do think there is a role there. The SROs are more nimble, as you have seen with their really elegant fix on

customer funds protection by going right to the banks and having that happen. That went a lot quicker than I suspect the Commission could have done it, and it is actually very effective, and to me, may be effective enough that you can look at your proposed fixes on customer protection and maybe leverage that one better.

On the path forward what the CFTC and the European Commission agreed to, you say we are going to agree to agree, yet you didn't agree on margins for exchange-traded derivatives. If at the end of the day you decide U.S. has one margin level, and the EU has a different margin level, what impact does that have on customers?

Mr. WETJEN. Thanks for the question, Mr. Chairman. I do think that at the end of the day even though you are right in the document that was released the document addressed this issue that effectively punted on it, I expect that the Europeans will find our clearing regime comparable to theirs. I would imagine that we will do the same although we do have most of the European clearinghouses either registered with us or in the process of registering with us. So that solves a lot of the problem there. Once comparability is determined, then we have to leave it up to the market participants to decide even if it means that in one clearinghouse there is larger, more additional margin requirements *vis-à-vis* another.

What we have to keep an eye out for is why we want participants to have choice in that way, or we want to make sure that there aren't the sorts of arbitrage taking place that would invite risk to our system, because in this case we actually have a smaller margin requirement. So we would want to keep an eye out for that, but based on initial dialogues between ESMA and Europe and the staff at the CFTC, it feels to me like we are trending towards a conclusion where equivalency or substituted compliance is going to be found.

The CHAIRMAN. All right. Anyone else have another question? Mr. Vargas, 5 minutes.

Mr. VARGAS. Thank you very much, Mr. Chairman. I appreciate it. I appreciate again the witnesses being here. You know, the question was asked by Mr. Maloney what keeps you up at night? And you said your 3 year old. If your 3 year old is keeping you up, you are doing something wrong, but only by 1 year, and then after that, they shouldn't be keeping you up. I have two girls; I can tell you.

But anyway, Mr. Costa said what worries you in the middle of the night and I guess I thought about that. And from my district it is an interesting district because about ⅔ of the district is a very urban area in San Diego and the other part of my district is a very rural farming community. And for them it is the issue of manipulation of some commodities like gasoline. In California back in the early 2000s we had manipulation of the electrical system there, and our prices spiked two, three times what they were regularly and I went back and took a look at the price of gasoline here. And this is the weekly U.S. conventional gasoline retail prices since 2000. In 2000 both premium and regular was under $1.50, and today, they are $3.82 and $3.50 for premium/regular.

That is one of the things that worries people in my district. You know, what has happened to the price of gas? And there are economists and academics that are saying it is manipulation and speculative manipulation, very similar to that. I don't know that that is true. Now, you said that there is this process that you go through but how would you find that? When you are having these meetings, how would you determine that there is manipulation through speculation? Because really that is what Dodd-Frank ultimately is supposed to do. It is where the rubber hits the road is where the regular American is saying, "Wait a minute, I am getting ripped off here. I am paying way too much and this is not market forces. This is manipulation. This is speculation. This is something that is wrong and fraudulent." How in fact do you find it there because I know that that is an issue that comes up in California, the price of gas and these radical increases that we have seen?

Mr. O'MALIA. This is an issue that we are very attuned to based on the California energy crisis and obviously in 2007 a lot of commodities saw their prices spike and fall in 2007. And they have remained more moderate but we have to be vigilant, absolutely have to be vigilant on this point. We have to work with our surveillance teams, which are really growing in capacity, and I am very impressed. One area that I think we are really improving in is our ability to analyze the data. It is not so much the new data but it is that we are really expanding our capacity. And I give a lot of credit to our new office surveillance director, Matt Hunter, for his efforts to retool our teams to really become more data-intensive and to do a lot more modeling. We are making huge improvements there.

We also work with EIA, the Energy Information Agency, which really looks at physical stores and making sure we understand how the physical markets are behaving, storage issues, supply and demand, and those are vital issues to make sure that when we look at something, are we looking at a supply-and-demand issue or are we looking at a manipulation issue?

And then some of the other things we work on with the FTC, Federal Trade Commission, things like gasoline prices, they have investigated gasoline issues over the years on and off and tried to figure out why the price of gasoline, why does it go up faster than it comes down, for example. So we work with all of these entities, including FERC, by the way, in electricity issues as well.

So we put that together. Our mandate is to make sure that we don't have fraud or manipulation in our markets and we figure out if there is somebody doing that, how do we go about it? In Dodd-Frank, we have new manipulation authority that really makes our job easier in terms of pursuing a suspected manipulation case. In pursuing a case, Congress gave us the recklessness standard which effectively lowers the bar for us in terms of proving manipulation.

Recently, we have also had new disruptive trade practices authority and we recently prosecuted the other day, or at least came to a settlement with, a high-frequency trader who is using spoofing. That was the first time we ever used our spoofing authority that was given to us under Dodd-Frank. In addition to the farm bill in 2009, I believe, we also raised the penalty for manipulation to $1 million per violation.

So we have a number of tools in our toolbox today. Congress has given us easier authority to prosecute these things. And then the other big issue is going to be data. We are now going to have the ability eventually to look at the swaps data so we can work with our physical partners to look at physical market data, EIA, supply-and-demand data. We are going to have swaps data. So that market is no longer going to be dark to the Commission. We need to make sure that we understand how the physical market trades and the interaction between financial markets.

Mr. VARGAS. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. Mr. Scott for a closing statement.

Mr. DAVID SCOTT of Georgia. Well, this has been a very informative session, and you both handled your testimony in a very intelligent, knowledgeable way. It has provided us with tremendous insight. You do an extraordinary job. You have taken on an extraordinary situation. And, as I mentioned before, it is important to note a great commendation to your staff who has had to work overtime, as I said. You have not had a reauthorization since before Dodd-Frank, since before the financial crisis. A lot has been thrown at you. It is very important that you have the staffing, as I have reiterated in my line of questioning. Thank you for your testimony, and thank you for the great service that you are providing to our nation.

The CHAIRMAN. Thank you, Mr. Scott. And I would echo those compliments. Thank you both for being here. In the boxing world, it doesn't appear we laid a glove on either one of you in this morning's exchanges. Thank you very much for what you do. Thank you for your staff and their hard work and we berate you when something goes wrong; we don't brag on you enough when you get it right. I appreciate both of you, and your very open attitudes toward exchanging ideas. I hope we were as adept at listening to you as well.

Under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material, and supplementary written responses from the witnesses to any question posed by a Member.

This hearing on the Subcommittee on General Farm Commodities and Risk Management is adjourned.

[Whereupon, at 11:52 a.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED QUESTIONS

Response from Hon. Scott D. O'Malia, Commissioner, U.S. Commodity Futures Trading Commission

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

General Commission Operations

Question 1. Are there any programs or divisions of the Commission that should be cut or consolidated?

Answer. First, in order to determine whether certain programs or divisions of the Commission should be cut or consolidated, the Commission must do a better job at identifying its mission and budget priorities, particularly in light of the fiscal challenges facing the nation. For example, the Commission has failed to establish a clear business plan by division that incorporates the specific technology requirements each division will need over the next 5 years. Without such a strategy, ambitious goals to integrate technology into the mission of each division are easily forgotten—especially when there are no specific goals or timetables for deploying technology to modernize the Commission into a 21st century regulator.

Second, the Commission must clarify how to coordinate new registration oversight and compliance responsibilities with the Self-Regulatory Organizations (SROs) so that limited resources are maximized and efficiently used. For example, it doesn't make sense for the Commission to duplicate the role of the National Futures Association (NFA) by reviewing each and every swap dealer submission and 168,000 pages of swap dealer documentation for registration compliance. It is unclear how the 50% funding increase for the Division of Swap Dealer and Intermediary Oversight (DSIO) that is in the Commission's fiscal year 2014 budget request will be utilized, and how the Commission will rely on the NFA to execute this mission.

Finally, it must be a priority of the Commission to develop a cross-divisional team of staff to focus on resolving the challenges surrounding our data reporting and data utilization efforts because the Commission's efficient operation is dependent on the effective use of data. This will allow staff, especially the Division of Enforcement (DOE) and the Division of Market Oversight (DMO), to conduct surveillance of the markets and fulfill their mission in a reliable and expedient manner. The Commission is struggling to accept, interpret, and aggregate data from the three temporarily-registered swap data repositories (SDRs), and this problem will be compounded with the additional data received from international sources. I believe that only through a dedicated effort can the Commission address our most pressing market oversight challenge—data. I am committed to working with the members of the Technology Advisory Committee (TAC), which I chair, to support the standardization of data.

Question 2. Can you please explain what "absent objection" currently means in the context of the issuance of a CFTC staff "no action" letter, or other Commission action, and how it is used?

Answer. It is important to recognize that the "absent objection" process is not defined in the Commodity Exchange Act (CEA) or in Commission regulations. The lack of official procedure has led to confusion and misunderstanding regarding the exact role of the Commission with respect to staff action, and whether absent objection circulation by the staff to the Commission constitutes a Commission vote. While the Office of the General Counsel (OGC) has provided some context for the absent objection process, none of the procedures described below by OGC are included in Commission regulations.

As a practical matter, the current absent objection process is to put into circulation a matter (such as a staff no-action letter to provide relief from Commission rules) and notify the office of each Commissioner that "absent objection by the majority of the Commission," the staff action will proceed and any referenced document(s) will be released. Notably, the Secretariat always contacts each Commissioner's Office to see if there is any objection to staff action.

Due to the lack of formal procedure, I received two conflicting views about the role of the Commissioners' vote (*i.e.,* whether or not to object) in the absent objection process. Initially, I was informed by the Secretariat that three votes are required to stop staff action from going forward, although this standard has never been applied. But later on, I was informed by the General Counsel in an e-mail dated July 12, 2013, that the Commission cannot block staff action because an absent objection circulation is not a vote.

Now, in connection with these *Supplemental Questions for the Record,* I have received the following advice from OGC regarding absent objection:

In order to explain the "absent objection" process at the Commission, it is helpful to understand how business is conducted generally at the Commission. As is the case with other independent agencies in the federal government, the operations of the Commission and its staff are governed by Congressional mandate. The Commodity Exchange Act ("CEA") distinguishes among actions taken by the Chairman, Commission action, and staff action.

Under CEA § 2(a)(6)(A), the executive and administrative functions of the Commission are exercised solely by the Chairman. In carrying out these functions, the Chairman is governed by general policies, plans, priorities, and budgets approved by the Commission, and by such regulatory decisions, findings, and determinations as the Commission has made. *See* CEA § 2(a)(6)(B).

Staff action occurs under the authority of Section 2(a)(6) and under authority specifically delegated by the Commission. *See, e.g.,* 17 CFR §§ 140.14, 140.20, 140.72–140.97 (2013). The staff's issuance of no-action letters, interpretive letters, and exemptive letters is authorized by Rule 140.99, 17 CFR § 140.99 (2013).

Commission action is accomplished by a majority vote of the Commissioners. See *FTC* v. *Flotill Prods., Inc.,* 389 U.S. 179, 183–84 (1967) (absent a specific statutory requirement, federal agencies follow the common law 'majority of a quorum' rule). Such action occurs in two ways: through votes held at formal meetings, or through seriatim consideration under Rule 140.12. *See* 17 CFR § 140.12.

With that background, the term, absent objection, can arise in two contexts. It usually refers to an informational circulation to the Commission to describe action to be taken by Commission staff. Although conducted through the Office of the Secretariat, the process does not call for a Commission vote. It is intended to keep the Commissioners apprised of the staff's activities that are taking place under the Chairman's supervision.

In addition, business may proceed on an "absent objection" basis at Commission meetings. If a Commissioner objects, the matter is decided by majority vote.

As indicated above, the Commission also conducts business through seriatim votes without holding a formal meeting. If a Commissioner objects to seriatim consideration, the matter is withdrawn from seriatim consideration, and is scheduled for disposition at a Commission meeting. *See* 17 CFR § 140.12(b).

It is still unclear from the advice provided by OGC what is the appropriate use of the absent objection process, and whether a majority of the Commission or a single Commissioner may object to staff action and request reconsideration of a matter before it is released.

In light of the recently expanded universe of matters that now proceed by absent objection circulation and their far-reaching consequences, such as the extension of subpoena authority under omnibus orders of investigation and the issuance of indefinite relief from Commission rules via staff no-action letters, the Commission or Congress should define the appropriate use of the absent objection process. Historically, absent objection circulation was utilized for matters like NFA rule amendments or limited no-action relief for a single entity, not a broad class of persons or products.

Finally, I would draw the Committee's attention to the advice provided by OGC regarding the Chairman's authority under CEA § 2(a)(6)(A), which limits the Chairman's executive authority to executive and administrative functions. This authority does not appear to give the Chairman unilateral power over policy decisions of the Commission or changes to Commission rules or regulations. In particular, I am seriously concerned that, at the Chairman's direction, the staff has been issuing indefinite no-action relief from existing rules—which, in essence, amounts to *de facto* rulemaking—without a Commission vote. At the very least, there must be an opportunity for one Commissioner to object to the proposed staff action and have the matter considered further.

Question 3. Is there an official legal procedure for utilizing an "absent objection" motion at the CFTC? Has there been a change in the legal interpretation of what "absent objection" means between past and current usage of this procedural motion for Commission business?

Answer. There are currently no Commission regulations that govern the "absent objection" process. I would welcome a review of the Commission's policies and procedures and recommendations to establish clear process for staff action and Commission action.

I received the following advice from OGC on procedure and its legal interpretation of past and current usage of "absent objection":

As explained above, Commission action may be taken on a matter during formal meetings of the Commission by majority vote or by an "absent objection" process. Regardless of which way it is proceeding, each matter is considered by the Commission pursuant to a motion made by one of the Commissioners. Each matter typically includes a staff memorandum to the Commission explaining the proposal under consideration. If objection is heard to a matter presented by an "absent objection" motion, the matter becomes subject to disposition by majority vote.

With respect to staff business that proceeds on an "absent objection" basis, as described in response to *Question 2* above, the procedure is to circulate informational memoranda so that the Commissioners may be informed of a staff action and the Chairman may be informed of any Commissioner's objection to the planned staff action. If there are such objections, the Chairman may choose to withhold such staff action.

The CFTC and its Office of the General Counsel have consistently interpreted these terms in this way.

Now, based on OGC's current opinion, the Chairman has the discretion to withhold an absent objection circulation if one Commissioner objects. It appears that, yet again, OGC is revisiting its interpretation of this process.

Moreover, as I noted in my response to *Question 2,* the Secretariat is operating on a completely different basis: the "absent objection" process means "absent objection *by a majority* of the Commission" (emphasis added).

The Secretariat's practice blurs the line between staff action and Commission action. By requiring a majority to object in order to stop staff action from going forward, the process seems to call for a Commission vote. Such a vote would make an "absent objection" circulation not opposed by a majority of the Commission more similar to ratification by the Commission of staff action. This reinterpretation of "absent objection" appears to have no foundation in the common law, parliamentary procedure, or past practice at the CFTC and other agencies.

I question whether this reinterpretation of the "absent objection" process means (1) that staff action, absent the objection of a majority of the Commission, becomes ratified agency action that is reviewable by the courts under the APA, and (2) to the extent that staff action is deemed ratified by the Commission and has a practical binding effect on the rights and obligations of parties, or a binding legal effect, then it is a rulemaking done without notice and comment as required by the APA.

Question 4. Procedurally, I understand that a 2–2 Commission vote prevents an order from being issued, yet a 3–1 vote is required to stop an "absent objection" motion? Why?

Answer. As you will see from the advice provided by OGC below, there is no explanation why a 3–1 vote is required to stop an "absent objection" circulation. Because it is more difficult to obtain a 3–1 vote than a 2–2 vote, I believe that a 3–1 vote makes it more difficult to stop staff action from going forward, than a 2–2 vote which is not enough to pass a Commission order. This produces a nonsensical result.

I received this advice from OGC on the number of votes required to stop an "absent objection" circulation:

> With respect to an "absent objection" motion at a formal meeting, if an objection is heard, the matter becomes subject to disposition by majority vote.
>
> With respect to staff action circulated "absent objection," unless a statute or prior Commission order requires otherwise, the Chairman's prerogative as staff director controls, and he may, in his discretion, direct a different course preferred by fellow Commissioners.
>
> As mentioned above, Commission action is accomplished by a majority vote of the Commissioners. *See FTC* v. *Flotill Prods., Inc.,* 389 U.S. 179, 183–84 (1967). A 2–2 vote is sufficient to stop such action.

Question 5. Do you think it is appropriate for CFTC staff to be given the power to unilaterally initiate investigations, without the opportunity for the CFTC Commissioners to provide a check on that power?

Answer. It is appropriate for DOE to initiate informal investigations with voluntary compliance by subject parties, which was delegated to DOE under Rule 11.2 in Commission regulations. However, Rule 11.4 explicitly reserves the authority to initiate formal investigations to the Commission. Formal investigations permit the use of subpoena authority to compel compliance by subject parties. Only an order by the Commission can authorize the issuance of a subpoena.

For some reason, as evidenced below, OGC does not distinguish between these two types of enforcement actions, even though subpoena power drastically affects the rights of subject parties.

With respect to the Commission's subpoena authority, it is not appropriate for the Commission to delegate subpoena power to DOE for an extended period of time without the opportunity for a Commission vote. This subpoena power must reside with the Commission, pursuant to Rule 11.4.

Recently, the Commission approved two omnibus orders of investigation that authorize DOE to extend the duration of subpoena power without a Commission vote because the language in these omnibus orders would allow their continuous renewal, "absent objection by the Commission." Since OGC has determined that the absent objection process does not constitute a Commission vote, it is not appropriate for the Commission to use this process to extend the delegation of the Commission's subpoena authority.

Below is the advice that I received from OGC on investigations:

> Yes, I believe that the Commission's current procedure and practice for investigations promotes the efficient and effective use of Commission resources, while including measures to safeguard the Commission's oversight responsibility.
>
> The Commission's authority to conduct investigations is broad. The Supreme Court has held that administrative agencies have the authority to "[i]nvestigate merely on suspicion that the law is being violated, or even just because it wants assurance that it is not." *United States* v. *Morton Salt Co.,* 338 U.S. 632, 642–43 (1950); *see CFTC* v. *McGraw-Hill Cos.,* 390 F. Supp. 2d 27, 33 (D.D.C. 2005) (same).
>
> In 1976 the Commission delegated to the Director of its Division of Enforcement, and to the Directors of the Commission's other operating divisions, the authority to conduct investigations and make recommendations to the Commission therefrom. CFTC Rules Relating to Investigations, 41 *Fed. Reg.* 29798 (July 19, 1976) (adopting Part 11 to the Commission's Rules, including Rule 11.2 (Authority to conduct investigations)). The purpose of an enforcement investigation is to discover the facts so that the Commission may determine whether it is necessary or appropriate to institute an enforcement action or take other preventive, remedial or punitive action. *Id.*
>
> Over the past 4 fiscal years, the Commission's Division of Enforcement has opened more than 1,500 investigations of potential violations of the Commodity Exchange Act or Commission Regulations. Requiring Commission review and approval for each investigation would reverse a nearly 40-year-old Commission delegation that has worked well, cause an undue burden on the Commission's resources and stifle the effectiveness of its enforcement program.
>
> The Division of Enforcement provides the Commissioners with regular briefings regarding the status of significant investigations. Further, Commissioners regularly request and receive updates from the Division of Enforcement regarding the status of investigations of particular interest. In the course of an investigation, the Division of Enforcement may seek authorization from the Commission to compel production of records and or testimony through Commission order authorizing issuance of subpoenas.
>
> Also, while the Division of Enforcement may make a recommendation based upon its investigation, the Commission has the sole authority to make the determination as to whether or not to file an enforcement action.

Question 6. Per Commission regulations, what is an "omnibus order"? What is the permissible scope of an "omnibus order" granting subpoena power to CFTC staff, and how long should such an order be effective? If the order has an indefinite duration, would it be binding on a future Commission?

Answer. Commission regulations relating to investigative powers of the Commission do not reference omnibus orders. Further, Commission regulations do not define an omnibus order, nor do Commission regulations describe the permissible scope and duration of an omnibus order. I find this troubling, because the process by which the Commission initiates and issues subpoenas is the foundation of any enforcement action.

Because omnibus orders are not in Commission regulations, I have to rely on existing rules related to the issuance of an individual subpoena by the Commission under Rule 11.4 and on informal OGC advice to determine whether a particular omnibus order meets the necessary legal requirements—not a clear standard set forth in Commission regulations.

For example, I received this advice from OGC regarding omnibus orders of investigation:

> Authorization to issue subpoenas directed at a particular subject area is commonly referred to as an omnibus formal order.

OGC further explained that the content of a subpoena should, among other things:

> [The subpoena should] *provide a general description of the scope of the investigation*, the authority under which the investigation is being conducted, and designate the individuals authorized to issue subpoenas. The scope of the investigation subject to such an order may be directed at compelling information and testimony concerning a *particular entity's course of conduct* or to a particular subject matter area.

(emphasis added).

Unfortunately, a handful of requests that landed on my desk from DOE for issuance of an omnibus order of investigation fall short of these minimum standards. The orders simply mention categories of registrants, not a specific entity or entities, and refer to potential violations of the CEA that may be committed at some point in the future by these categories of registrants. The lack of any specific information or particularity in these omnibus orders allows DOE to issue subpoenas without having the Commission review and vote on each subpoena based on the facts and circumstances of each investigation.

OGC also advised me that omnibus orders are essential for conducting effective enforcement programs. OGC states:

> At times, CFTC investigations require quick enforcement action to freeze assets belonging to customers, preserve books and records and, sometimes, coordinate the expedited filing of related actions in cooperation with other civil or criminal authorities.

It is not clear to me how a broad omnibus order, which does not even mention a specific entity that is subject to an investigation, can help DOE freeze assets and preserve books and records of a specific company on an expedited basis.

Such "quick enforcement action" can only be achieved when DOE, after obtaining the necessary authorization from the Commission, files a complaint and a motion for preliminary injunction in a federal district court requesting that the court issue a restraining order allowing the Commission to freeze assets and ordering the defendants to preserve books and records.

Regarding the duration of omnibus orders, I believe that omnibus orders should be confined to a limited time period. I also believe that the Commission must retain the power to grant an extension of omnibus orders through Commission action (*i.e.,* a vote by the Commission). Congress intended that a decision to bring or extend an investigation is reflective of a shared opinion of the majority of the Commissioners, rather than a unilateral ruling of DOE staff.

As I stated before, I support the robust use of the Commission's enforcement authority to thwart fraud, manipulation, and abuse in CFTC-regulated markets. Accordingly, I support the use of omnibus orders, but only if the scope, duration, and permissible use of such orders is clearly defined in Commission regulations. I welcome Congressional action to amend the CEA to define the appropriate use of omnibus orders as well.

Question 7. What is the legal justification for the Commission issuing a final "exemptive order" without prior notice-and-comment periods? Does this place Commission actions on questionable legal ground from a compliance standpoint with the Administrative Procedures Act?

Answer. I received the following advice from OGC:

> The APA empowers an agency to proceed without notice and comment for good cause. *See* 5 U.S.C. § 553. The Commission has interpreted CEA Section 4(c), which authorizes the Commission to grant exemptive relief, to incorporate the APA's requirements, including the good cause exception. The Commission's view is that Congress did not intend that the Commission can impose requirements on market participants without notice and comment when there is good cause, but may not exempt market participants when the public interest dictates, or other good cause exists, without first allowing a comment period.

Recently, the Commission issued an Exemptive Order from the cross-border swaps guidance without prior notice and comment by utilizing the good-cause exception in the APA. It is my understanding that courts have narrowly construed the good-cause exception from notice-and-comment and placed the burden of proof on the agency to demonstrate exigent circumstances. *See Tenn. Gas Pipeline Co.* v. *Fed. Energy Regulatory Comm'n,* 969 F.2d 1141 (D.C. Cir. 1992); *Guardian Fed. Sav. & Loan Ass'n* v. *Fed. Sav. & Loan Ins. Corp.,* 589 F.2d 658, 663 (D.C. Cir. 1978).

I find it troubling that, notwithstanding the case law, the recent Exemptive Order stated the deadline of July 12, 2013 (which was arbitrarily set by the Commission)

as the basis for an "emergency" necessitating the abrogation of the public's right to participate in rulemaking. Further, the Exemptive Order's inclusion of a *post-hoc* comment period does not, in and of itself, satisfy APA notice-and-comment requirements because the public must have the opportunity to comment *before* any rulemaking becomes final.

Question 8. After the "*post hoc*" comment period has closed for some exemptive orders, will the Commission allow revisions to be made based on issues raised by the public comments?

Answer. I received this advice from OGC:

> In its informed discretion, the Commission may vote to allow such revisions.

Notably, only the Chairman can schedule a meeting to consider amending exemptive orders or other rulemaking.

Question 9. Are there written rules or policy guidelines on how the CFTC is to use the "no action" letter process? If not, does the Administrative Procedures Act govern the use or issuance of staff "no action" letters?

Answer. Section 140.99 of Commission regulations sets forth procedures for requesting no-action relief. In addition, Section 140.99 plainly states that a no-action letter does not bind the Commission, it does not bind other Commission staff besides the issuing Division, and it cannot be relied upon by the public to govern their market activities.

I strongly believe that the Commission misused no-action relief by setting forth significant Commission policy that affects large swaths of market participants and engaging in rulemaking that implements the Dodd-Frank Act.

This is starkly illustrated by the fact that of the over 100 no-action letters granted to date under our new rules and regulations implementing Dodd-Frank, at least 23 no-action letters have no expiration date. This *ad hoc* process of issuing no-action relief is confusing and inconsistent, and in the case of indefinite relief, a *de facto* rule change.

Again, I am concerned that a no-action letter that is effective for an indefinite period of time essentially amounts to a rulemaking, but does not adhere to APA safeguards that ensure public participation and transparency.

As is consistent with historical practice and other agencies' practice, no-action relief should be used sparingly, for specific entities based on a particular set of facts and circumstances, and on a time-limited basis. Any shortcomings in a final rule issued by the Commission must be resolved through rulemaking under the APA to properly amend the rule.

I welcome Congressional oversight of the Commission's use of no-action relief to determine whether the Commission is in compliance with the APA.

Regarding the current procedure for no-action relief, I received the following advice from OGC:

> CFTC Rule 140.99 sets forth the parameters. It states that a CFTC staff no-action letter is "a written statement by the staff of a Division of the Commission or of the Office of the General Counsel that it will not recommend enforcement action to the Commission for failure to comply with a specific provision of the [CEA] or of a Commission rule, regulation or order if a proposed transaction is completed or a proposed activity is conducted by" the beneficiary of the letter. The Rule states that the no-action letter represents the views of the Division that issued it or the Office of General Counsel and does not bind the Commission—it binds only the issuing staff and not the Commission or other Commission staff. It states that only the beneficiary may rely on the letter. *See* 17 CFR 140.99(a)(2).
>
> The Rule also sets forth a host of requirements, including that the letter will be issued in response to proposed transactions only, and not completed transactions unless there are extraordinary circumstances. *Id.* § 140.99(b)(3). Staff also will not respond to no-action requests posing hypothetical questions. *Id.* The proposed beneficiary must be identified, *id.* § 140.99(b)(4), and additional specified information must be provided, *id.* § 140.99(c). For the complete set of requirements, *see* 17 CFR § 140.99(c)–(d); *see also id.* § 140.99(e) (concerning the form of a staff response).

Customer Protection

Question 10. Is the Commission's ability to perform adequate market surveillance critical to protecting futures and swaps customers? Should the CFTC's "Customer Protection" fund be utilized to make needed improvements to the Commission's technological capabilities? Why or why not?

Answer. Yes, the Commission's ability to perform adequate market surveillance is critical to protecting futures and swaps customers, and the effective use of technology is an essential element of adequate market surveillance. I do not believe that the Commission has made the necessary investments in technology to keep up with our expanded oversight mission under the Dodd-Frank Act. The need for investments in technology is especially highlighted by Dodd-Frank because its provisions bring the swaps market under surveillance and regulation for the first time.

Regarding the Customer Protection Fund, under the Dodd-Frank Act, Congress authorized the Commission to utilize the $100 million balance in the Customer Protection Fund for two purposes: (1) to pay whistleblowers and (2) to educate customers. To date, we have not paid any whistleblowers and we have spent just 1% of the fund, annually, on customer education. Of that amount, the bulk has been spent on salary and benefits for the Whistleblower Office and the Office of Consumer Outreach. The next largest line item for the fund is a consultant to identify customers that require education and training, followed by an audit of the fund's financial statements.

Customer protection has been neglected and this area is ripe for additional investment. I suspect that Congress had a better vision for the Commission's customer protection efforts than what has been done thus far.

It is clear that the Commission's capacity to use technology to perform improved market surveillance, monitor risk, and implement tools to enhance customer protections could be enhanced. One of the most critical aspects of the CFTC's mission is to protect market participants and the public from fraud, manipulation, abusive practices and systemic risk. In order to fulfill its mission, the Commission must have the ability to effectively conduct surveillance of the swaps and futures markets.

The Commission is projected to return over $1.2 billion in civil monetary penalties to the U.S. Treasury to offset the deficit since the inception of the Fund. That $1.2 billion would have otherwise been eligible for transfer into the Customer Protection Fund, and could have been spent on technology investments to improve our market surveillance.

I would encourage Congress to carefully consider if there are other purposes for these funds that will help the Commission in its mission to protect market users, while still maintaining adequate resources to compensate whistleblowers.

Question 11. In light of the automated account verification system recently implemented by NFA and CME, does the CFTC still need read-only access to all Futures Commission Merchant customer fund accounts?

Answer. There are serious concerns in providing the Commission with access to all FCM customer fund accounts. It is also important to keep in mind that NFA and the Chicago Mercantile Exchange (CME) have implemented an automated account verification system that checks the balances in customer accounts daily, thus eliminating the need for the Commission to duplicate this function.

The draft customer protection rule contained a proposed requirement that all banks holding customer funds ("custodian banks") provide the Commission with direct access to customer account information. This direct, read-only access to every customer account used by FCMs would involve the sharing of all relevant account information and passwords for each account, and new passwords every time an account password is changed.

I have serious concerns with this requirement for two practical reasons. First, we don't have the staffing necessary to perform the manual checks needed to make this system an effective deterrent. Instead, both the Commission and customers would be better served by relying on the current, automated system implemented by NFA and CME that provides daily verification of segregated balances at the FCM and custodian bank.

Second, creating direct access to these accounts poses a higher cybersecurity threat relative to "push" technologies currently being utilized. This concern was raised at a TAC meeting. Moreover, maintaining and securing all the variable passwords and account information for every bank, FCM, and customer account would be a daunting task.

A better approach would be to utilize the current automated system implemented by NFA and CME and amend our regulations to require all FCMs to only use custodian banks that agree to immediately provide customer account information to the Commission upon request. By using this two-pronged approach of daily automated account verification, combined with the ability of the Commission to contact custodian banks directly and obtain account information in an emergency, the Commission will be able to protect customer funds in an efficient and expedient manner.

Question 12. Is reliance on the automated verification system utilized by CME and NFA a more secure method of accomplishing the same ultimate goal of protecting the integrity of customer funds?

Answer. I believe the automated system established and paid for by the market participants is a cost-effective early warning system that can identify unexpected changes in customer account balances. If account values change beyond a specific threshold from one day to another, the SROs and the Commission will be alerted and will be able to take immediate action to investigate.

Question 13. Do you think an exemption or some other form of protection should be made for small to medium-sized futures commission merchants pertaining to the level of excess margin required to be held under the CFTC's proposed customer protection rule?

Answer. The residual interest proposal in the rule has caused widespread concern within the industry. The practical effect of this rule would require FCMs to maintain a level of excess margin so that one customer's excess margin is never used to fund the margin shortfall of another customer. This increased capital contribution by the FCM will most likely be passed on to customers. Large institutional clients are not significantly burdened by this pass-through of costs. However, this pass-through of costs would impose serious financial constraints on the business operations of farmers and other end-users.

The Commission needs to reconsider the residual interest proposal to identify a process that adheres to the requirements of the CEA, yet places the least financial burden on end-users and the smaller FCMs that service them. It is imperative that we follow Congress' mandate and impose the least regulatory burden on end-users as we implement the Dodd-Frank Act.

Question 14. I find it fascinating that with all of the publicity over the cross-border rules and Chairman Gensler's warnings about how a failure to regulate entities in other countries would "blow a hole in Title VII"—that the accounts of the small farmer, farm cooperatives, and the public municipalities were not protected. Why did any guidance on cross-border regulation not include a solution related to how customer accounts should be treated when a multi-national FCM, like MF Global Inc., goes bankrupt? Or do you need a legislative solution?

Answer. I would welcome a Congressional solution to ensure that customer accounts are protected when a multinational FCM goes bankrupt. Without a doubt, customer protection—especially in bankruptcy—is a major factor in cross-border regulation. Both the still-ongoing Lehman Brothers' bankruptcy proceedings and the MF Global bankruptcy proceedings have taken years to resolve, delaying the recovery of U.S. customer funds. While the Dodd-Frank Act and financial reforms in other countries were intended to reduce the likelihood of future bailouts or failures, little has changed in the area of bankruptcy law.

Since over 90% of customer assets that are held in FCMs are held by jointly registered and regulated broker-dealers/FCMs, I would support increasing the authority of the CFTC in the bankruptcy proceedings for these jointly-regulated entities. For example, in the case of MF Global, the Securities Investor Protection Corporation (SIPC) placed the firm into bankruptcy, with SIPC as its trustee and with the exclusive mandate to protect securities customers. Since the interests of futures customers may not align with securities investors, it makes sense for the Commission to have the power to appoint its own trustee who is familiar with the CEA.

Also, I believe Congress should pursue granting new authority to the Commission in the U.S. Bankruptcy Code to ensure that customers are first in order of priority in any distribution of assets of the estate by the bankruptcy trustee—a "super-lien" so customers are always first in line.

Finally, I believe Congress should carefully consider the *pro-rata* distribution rules in bankruptcy proceedings, including creating the opportunity for market participants to have the ability to establish third-party segregation accounts that will not be comingled in bankruptcy proceedings, as long as those market participants are willing to pay for the costs of third-party segregation. Currently, if there is a shortfall in segregation, customers share the loss proportionally. This is the law, whether customer funds are held in one account (comingled), or in a separate individual account. The Commission has explored various options, but has been unable to change the *pro-rata* requirements without statutory amendments.

End-User Issues

Question 15. In passing the Dodd-Frank Act, Congress made clear its intent to exempt end-users from bearing the additional financial and regulatory burdens brought on by the legislation. Keeping that intent in mind, why has the CFTC used such a low swap dealing threshold for Special Entities?

Answer. As I described in my testimony, I believe the Commission failed to provide certainty to end-users because it did not faithfully interpret both the letter and the spirit of the law to carry out Congress' intent to exclude end-users from the swap provisions of the Dodd-Frank Act. The Commission implemented vague rules that inadvertently brought end-users under the swap dealer definition, which creates uncertainty for end-users in their risk mitigation practices.

For example, it is not clear to me why only $25 million was set as the *de minimis* threshold for swap dealing with Special Entities. This low threshold has resulted in few counterparties that are willing to trade with municipal utilities because of the concern that the counterparties will exceed the $25 million amount and thus be forced to register as swap dealers. Fewer potential counterparties means less competition for business, which in turn would mean widened bid-ask spreads. These widened spreads consequently mean greater costs for energy end-users.

The end result would be that these increased costs are passed on to the final energy consumers-the general public.

Question 16. Why do you think the Commission failed to completely exclude commercial end-users from regulation even after Congress made clear its intentions were not to regulate end-users who use swaps to hedge or mitigate risks from their business?

Answer. As I mentioned above, the main reason why the Commission has not excluded end-users from regulation is that it has ignored express Congressional directives to do so. The Commission has promulgated rules under the Dodd-Frank Act that are so broad and far-reaching that they require end-users to comply with virtually all of the new regulations.

In response to the outcry by end-users and Members of Congress, the Commission has issued a series of no-action letters and exemptive relief to alleviate some of the enormous regulatory burdens that now face end-users. However, this patchwork of regulatory relief is insufficient and fails to provide end-users and the market generally with clear guidance on their regulatory obligations and the current state of the law.

Because the Commission has failed to address this issue properly, Congress must now correct the Commission's error and specifically exclude end-users from the numerous regulatory burdens now imposed on them as a result of the Commission's implementation of Dodd-Frank.

Question 17. Do you agree that forward contracts containing terms providing some form of flexibility in delivered commodity volumes—otherwise known as "volumetric optionality"—should fall underneath the scope of the forward-contract exclusion? Why or why not?

Answer. Forward contracts with volumetric optionality should be included in the forward-contract exclusion. If the Commission fails to do so, then Congress should amend the CEA to specifically include volumetric options in the forward-contract exclusion from the swap definition.

In the final swap definition rule, the Commission left open the question whether contracts for the delivery of commodities with variability in the delivery amount fall within the definition of a forward contract. To determine whether a contract would qualify for the forward-contract exclusion, the Commission set forth a complicated seven-part test in the final rule that would call on market participants to establish each of the seven factors in order for their volumetric contracts to be classified as forwards.

However, the seventh factor caused a lot of anxiety among end-users. The Commission interpreted this factor as requiring market participants to determine whether their exercise or non-exercise of volumetric optionality is based on factors outside their control—not on the economics of the option itself. Quite often, one counterparty will enter into multiple volumetric option contracts in the hopes of securing both supply of needed resources and the best possible price. By prohibiting counterparties from exercising these options because they offer the best price, the Commission limits their ability to operate their business efficiently and restrains competition in the market place.

The Commission should amend the swap definition rule to include volumetric options within the forward exclusion if the first six parts of the test are met. Satisfaction of the seventh factor is not necessary and should not be a requirement for classification as a forward contract.

Question 18. The definition of "financial entity" in the Commodity Exchange Act cross-references the banking laws and depends on whether someone is engaged in activity that is "financial in nature." In short, this definition has the potential to treat many end-users like hedge funds in certain circumstances. Has the CFTC provided any guidance for how the banking definition of activities that are "financial

in nature" applies in the context of Title VII for end-users? Is this something that Congress should address legislatively?

Answer. The Commission has addressed the conflict between the definition of "financial in nature" under the banking laws and risk management practices common to end-users in the futures and swaps markets, such as the use of treasury affiliates, by issuing indefinite no-action relief from the clearing requirement for swaps. This indefinite relief, which is essentially a clearing exemption, applies to swaps entered into solely by entities that meet the definition of "financial in nature" under the banking laws. The relief from the clearing requirement has no expiration date.

This is a prime example of a final rule with unforeseen consequences that adversely impacts end-users, but has been addressed through indefinite no-action relief—*de facto* rulemaking—instead of properly engaging in notice-and-comment rulemaking under the APA to amend the rule.

I would encourage Congress to clarify the definition of "financial entity" under the CEA and avoid any further shortcuts taken by the Commission. Using the definition of "financial in nature" under the banking laws applies unnecessary restrictions to certain end-users and interferes with their business operations. The definition also interferes with the Commission's mandate to ensure that the commodity markets are liquid and promote hedging and price discovery.

As an alternative solution, section 102(a)(6) of the Dodd-Frank Act sets forth a predominance test to determine whether or not a firm is a "nonbank financial company." Title I of Dodd-Frank applies an 85% standard for gross revenue from financial activity to determine if a company is predominantly engaged in financial activities, and ultimately, is a nonbank financial company. One could assume from this test that a *de minimis* amount is, therefore, less than 15% of gross revenue from non-financial activity.

Accordingly, I wonder whether the Commission should apply a similar 85/15 test as part of our *de minimis* exception in order to provide a bright-line test for end-users (both commercial and non-bank financial) to demarcate themselves from swap dealers.

Question 19. Non-deliverable forwards (NDFs) were not included when the Treasury exempted foreign exchange swaps and forwards, under its authority under the Dodd-Frank Act, resulting in unnecessary and costly regulation. Do you believe the CFTC has the authority to address this unintended consequence by issuing an exemption providing that NDFs be treated the same as foreign exchange swaps and forwards? Should Congress clarify its intent to include NDFs in the definition of "foreign exchange forward"?

Answer. Due to the specific characteristics of NDFs, they remain characterized as swaps despite their similarity to foreign exchange forward contracts. Since the publication of the CFTC's and SEC's final rule defining swap contracts, I have heard from numerous market participants about the need for exemptive relief for NDF contracts. NDFs are used by market participants as a means of mitigating commercial and financial risk in operating in emerging markets. The classification of NDFs as swaps creates numerous regulatory obligations such as centralized trading, clearing, and reporting. All this adds to the costs associated with trading contracts that are necessary for risk mitigation purposes. At present, there are no plans by the Commission to provide any relief for NDFs from compliance with the CEA and Commission regulations. In light of the Commission's inaction, Congress may be the only source of relief for market participants.

Question 20. The CFTC requirement to record phone conversations at grain elevators that occasionally take orders from farmers who want to hedge in the futures market has been an issue of concerned raised by numerous commercial end-users. Based on your understanding, was this requirement called for by the Dodd-Frank Act? If not, why did the CFTC propose such a measure? What level of data should be collected at grain elevators, if any? How could this data collection be required in a manner that is not overly burdensome and costly to this sector of the marketplace?

Answer. The Dodd-Frank Act does not require FCMs to record telephone conversations with customers. Even though Congress did not direct the Commission to implement such a requirement, the Commission promulgated it at the request of DOE in order to aid in the prosecution of future enforcement actions.

As a result of these changes, a grain elevator that also acts as an FCM to assist its customers in risk mitigation must now integrate new systems that will record telephone conversations with customers that lead to the execution of a futures transaction. This requirement is applicable, regardless of the amount of futures business conducted by the grain elevator, and is extremely burdensome and expensive for a small grain elevator with a very limited futures trading operation.

Unfortunately, this is another example of the Commission's failure to heed Congress' directive to exclude end-users from the new regulatory requirements of Dodd-Frank.

Swap Dealer Definition

Question 21. Would excluding SEF-executed trades from the *de minimis* calculation help achieve Dodd-Frank's goals of encouraging trading on SEF's and requiring clearing?

Answer. As I discussed in my testimony, excluding SEF-executed and cleared trades from the *de minimis* calculation will help end-users by providing regulatory certainty regarding the swap dealer definition and mitigates counterparty risk.

Position Limits

Question 22. As you know, a properly functioning positions limit regime is not only dependent on a clear understanding of deliverable supply for a particular commodity, but also on a workable hedge exemption process. In a stark change from historical practice, the CFTC's approach in its since-vacated position limits rule was to limit the availability of the *bona fide* hedge exemption to only a few specific types of transactions. The result was a hedge exemption that was nearly unworkable. Why did the Commission deviate from the Commission's well-functioning historical approach, and does the Commission plan on providing a more flexible hedge exemption in its forthcoming proposed rule?

Answer. I believe that any hedge exemption must be flexible and do a better job of understanding and acknowledging hedging activities in today's markets. Hedging is the foundation of the swaps and futures markets and a cornerstone of the way commercial firms run their businesses. Because of its importance, any action the Commission takes or considers taking must avoid hindering the hedging activities of commercial firms.

The vacated position limits rule failed to take such risk mitigation practices into account because its definition of hedging was too narrow and not workable. Under the vacated rule, many commonly understood and historically accepted hedging practices would not qualify for the rule's hedge exemption. In order to comply with the position limits set forth in the rule, commercial firms would have had to potentially curtail risk-reducing transactions that are necessary for them to run their businesses effectively. I do not believe that this was Congress' intent.

My belief is underscored by the fact that the Commission's position limits rule was struck down last year by the United States District Court for the District of Columbia. The court held that before setting position limits, the Commission is required by statute to determine whether position limits are "necessary and appropriate" to prevent excessive speculation in the commodity markets. Unfortunately, the Commission ignored the district court order to undertake the required analysis and is defending the position limits rule in the United States Court of Appeals for the District of Columbia Circuit. Concurrently with its appeal, the Commission is drafting a new rule all over again, instead of simply evaluating the necessity for position limits, which it should have done in the first place.

Question 23. Should Congress be more explicit in defining what exactly constitutes a "*bona fide* hedge"?

Answer. I would welcome Congressional action to clarify the definition of a "*bona fide* hedge," including the scope and level of permissible hedging activity. For purposes of both simplicity and consistency, the Commission must adopt one uniform definition of hedging activity, and the same definition should be applied to both swap dealers and major swap participants. Instead of providing a bright-line test for market participants, different Commission regulations include different definitions that apply depending on the circumstances.

I believe Congressional action is necessary if the Commission's upcoming position limit proposal fails again in providing a flexible hedge exemption that allows end-users to continue to use the futures and swaps markets to mitigate risk and effectively manage their operations.

Question Submitted By Hon. Doug LaMalfa, a Representative in Congress from California

Question. Some have suggested that the way to "fix" the special entity sub-threshold is for the CFTC to lower the *de minimis* registration threshold for the *entire* energy swaps marketplace to $25 million. What damage would be done to end-users, consumers, and the marketplace by lowering the registration threshold for all energy swaps to $25 million?

Answer. I believe that lowering the *de minimis* threshold for all energy swaps to $25 million would negate the explicit Congressional directive to exclude end-users

from the new regulatory requirements of the Dodd-Frank Act. Lowering the threshold for all energy swaps could create additional costs and regulatory burdens for end-users.

For example, as we have seen with utility special entities, fewer counterparties may be willing to trade energy swaps out of concern that they will surpass the $25 million amount and be forced to register as swap dealers. Due to the reduction of available counterparties, end-users that trade energy swaps might pay more in bid-ask spreads and pass the costs on to the general public.

Response from Hon. Mark P. Wetjen, Commissioner, U.S. Commodity Futures Trading Commission

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

General Commission Operations

Question 1. Are there any programs or divisions of the Commission that should be cut or consolidated?

Answer. Given the long-term fiscal challenges our country faces, it is important that every agency of the U.S. Government, including the U.S. Commodity Futures Trading Commission ("CFTC" or "Commission"), consider ways to streamline or otherwise eliminate unnecessary costs to the U.S. taxpayer. Although there will always be differences in opinion based on priorities and other considerations, I believe that the President's Budget and Performance Plan for the CFTC appropriately takes into account our nation's fiscal challenges while seeking the appropriate amount of resources—as well as their allocation within the agency—for the CFTC to pursue the mission given to it by Congress.

Please see the attached "Commodity Futures Trading Commission, President's Budget and Performance Plan for Fiscal Year 2014," * submitted to the Appropriations Committees in the U.S. House of Representatives and U.S. Senate in April 2013. Note that the attached Budget and Performance Plan highlights the CFTC's budgetary priorities and recommended allocations of staff and resources for the upcoming fiscal year.

Question 2. Can you please explain what "absent objection" currently means in the context of the issuance of a CFTC staff "no action" letter, or other Commission action, and how it is used?

Answer. Please see the following description of the "absent objection" process prepared by the CFTC's Office of General Counsel:

> In order to explain the "absent objection" process at the Commission, it is helpful to understand how business is conducted generally at the Commission. As is the case with other independent agencies in the federal government, the operations of the Commission and its staff are governed by Congressional mandate. The Commodity Exchange Act ("CEA") distinguishes among actions taken by the Chairman, Commission action, and staff action.
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> Under CEA § 2(a)(6)(A), the executive and administrative functions of the Commission are exercised solely by the Chairman. In carrying out these functions, the Chairman is governed by general policies, plans, priorities, and budgets approved by the Commission, and by such regulatory decisions, findings, and determinations as the Commission has made. *See* CEA § 2(a)(6)(B).
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> Staff action occurs under the authority of Section 2(a)(6) and under authority specifically delegated by the Commission. *See, e.g.,* 17 CFR §§ 140.14, 140.20, 140.72–140.97 (2013). The staff's issuance of no-action letters, interpretive letters, and exemptive letters is authorized by Rule 140.99, 17 CFR § 140.99 (2013).
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> Commission action is accomplished by a majority vote of the Commissioners. *See FTC* v. *Flotill Prods., Inc.,* 389 U.S. 179, 183–84 (1967) (absent a specific statutory requirement, federal agencies follow the common law 'majority of a quorum' rule). Such action occurs in two ways: through votes held at formal meetings, or through seriatim consideration under Rule 140.12. *See* 17 CFR § 140.12.
>
> With that background, the term, absent objection, can arise in two contexts. It usually refers to an informational circulation to the Commission to describe action to be taken by Commission staff. Although conducted through the Office of the Secretariat, the process does not call for a Commission vote. It is in-

* The document referred to is retained in Committee file, and can be accessed on the CFTC's website at: *http://www.cftc.gov/ssLINK/cftcbudget2014*.

tended to keep the Commissioners apprised of the staff's activities that are taking place under the Chairman's supervision.

In addition, business may proceed on an "absent objection" basis at Commission meetings. If a Commissioner objects, the matter is decided by majority vote.

As indicated above, the Commission also conducts business through seriatim votes without holding a formal meeting. If a Commissioner objects to seriatim consideration, the matter is withdrawn from seriatim consideration, and is scheduled for disposition at a Commission meeting. *See* 17 CFR § 140.12(b).

Question 3. Is there an official legal procedure for utilizing an "absent objection" motion at the CFTC? Has there been a change in the legal interpretation of what "absent objection" means between past and current usage of this procedural motion for Commission business?

Answer. Please see the following description of the "absent objection" process prepared by the CFTC's Office of General Counsel:

> As explained above, Commission action may be taken on a matter during formal meetings of the Commission by majority vote or by an "absent objection" process. Regardless of which way it is proceeding, each matter is considered by the Commission pursuant to a motion made by one of the Commissioners. Each matter typically includes a staff memorandum to the Commission explaining the proposal under consideration. If objection is heard to a matter presented by an "absent objection" motion, the matter becomes subject to disposition by majority vote.
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> With respect to staff business that proceeds on an "absent objection" basis, as described in response to *Question 2* above, the procedure is to circulate informational memoranda so that the Commissioners may be informed of a staff action and the Chairman may be informed of any Commissioner's objection to the planned staff action. If there are such objections, the Chairman may choose to withhold such staff action.
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> The CFTC and its Office of the General Counsel have consistently interpreted these terms in this way.

Question 4. Procedurally, I understand that a 2–2 Commission vote prevents an order from being issued, yet a 3–1 vote is required to stop an "absent objection" motion? Why?

Answer. Please see the following description of the "absent objection" process prepared by the CFTC's Office of General Counsel:

> With respect to an "absent objection" motion at a formal meeting, if an objection is heard, the matter becomes subject to disposition by majority vote.
>
> With respect to staff action circulated "absent objection," unless a statute or prior Commission order requires otherwise, the Chairman's prerogative as staff director controls, and he may, in his discretion, direct a different course preferred by fellow Commissioners.
>
> As mentioned above, Commission action is accomplished by a majority vote of the Commissioners. *See FTC* v. *Flotill Prods., Inc.,* 389 U.S. 179, 183–84 (1967). A 2–2 vote is sufficient to stop such action.

Question 5. Do you think it is appropriate for CFTC staff to be given the power to unilaterally initiate investigations, without the opportunity for the CFTC Commissioners to provide a check on that power?

Answer. In answering this question, it is important to distinguish between (1) the power of CFTC staff to initiate investigations and (2) the power of CFTC staff to compel testimony or the production of documents as part of an investigation. The CFTC's Division of Enforcement has broad, delegated authority to initiate investigations and obtain certain evidence through voluntary statements and submissions. *See* CFTC Rule 11.2(a). However, CFTC Rules 11.2(a) and 11.4(a) require that any exercise of delegated subpoena power by the CFTC's staff be granted by a formal order of the Commission. Given the importance of the CFTC's enforcement mission to protect the public, this longstanding investigatory authority delegated to staff is appropriate so long as the checks on that authority remain in place.

For additional information, please see the following description of the CFTC's investigative authority prepared by the CFTC's Office of General Counsel in consultation with the CFTC's Division of Enforcement:

> [T]he Commission's current procedure and practice for investigations promotes the efficient and effective use of Commission resources, while including measures to safeguard the Commission's oversight responsibility.

The Commission's authority to conduct investigations is broad. The Supreme Court has held that administrative agencies have the authority to "[i]nvestigate merely on suspicion that the law is being violated, or even just because it wants assurance that it is not." *United States* v. *Morton Salt Co.,* 338 U.S. 632, 642–43 (1950); *see CFTC* v. *McGraw-Hill Cos.,* 390 F.Supp.2d 27, 33 (D.D.C. 2005)(same).

In 1976 the Commission delegated to the Director of its Division of Enforcement, and to the Directors of the Commission's other operating divisions, the authority to conduct investigations and make recommendations to the Commission therefrom. CFTC Rules Relating to Investigations, 41 *Fed. Reg.* 29798 (July 19, 1976) (adopting Part 11 to the Commission's Rules, including Rule 11.2 (Authority to conduct investigations)). The purpose of an enforcement investigation is to discover the facts so that the Commission may determine whether it is necessary or appropriate to institute an enforcement action or take other preventive, remedial or punitive action. *Id.*

Over the past 4 fiscal years, the Commission's Division of Enforcement has opened more than 1,500 investigations of potential violations of the Commodity Exchange Act or Commission Regulations. Requiring Commission review and approval for each investigation would reverse a nearly 40-year-old Commission delegation that has worked well, cause an undue burden on the Commission's resources and stifle the effectiveness of its enforcement program.

The Division of Enforcement provides the Commissioners with regular briefings regarding the status of significant investigations. Further, Commissioners regularly request and receive updates from the Division of Enforcement regarding the status of investigations of particular interest. In the course of an investigation, the Division of Enforcement may seek authorization from the Commission to compel production of records and or testimony through Commission order authorizing issuance of subpoenas.

Also, while the Division of Enforcement may make a recommendation based upon its investigation, the Commission has the sole authority to make the determination as to whether or not to file an enforcement action.

Question 6. Per Commission regulations, what is an "omnibus order"? What is the permissible scope of an "omnibus order" granting subpoena power to CFTC staff, and how long should such an order be effective? If the order has an indefinite duration, would it be binding on a future Commission?

Answer. The authorization to issue subpoenas directed at a number of persons within a particular subject matter area, as opposed to a particular person, is commonly referred to as an "omnibus" order. The primary difference between an "ordinary" investigative order and an omnibus order is that the latter is not limited in scope to a particular person; it is, however, normally time-limited (although some have been re-extended). CFTC Rule 11.4(b) requires any CFTC order authorizing staff to issue subpoenas in the course of a particular investigation to include (1) a general description of the scope of the investigation; (2) the authority under which the investigation is being conducted; and (3) a designation of the members of the Commission or of its staff authorized by the Commission to issue subpoenas.

The CFTC has issued omnibus orders to investigate the proliferation of fraud in particular areas for over a decade. For example, on December 13, 1999, the CFTC issued an omnibus order to investigate certain entities suspected of engaging in the fraudulent marketing and promotion of Internet-based commodity trading advisory systems and services. Similarly, on January 21, 2001, the CFTC approved an omnibus order to investigate suspected fraud in retail foreign currency exchange ("forex") transactions following enactment of the Commodity Futures Modernization Act of 2000, which expanded the CFTC's jurisdiction over the forex market. Following these two orders, the CFTC issued an omnibus order on September 22, 2008 as part of its National Crude Oil investigation.

The CFTC's Division of Enforcement continues to rely upon targeted and time-limited omnibus orders in appropriate cases, and these orders are generally consistent with prior CFTC practice. For example, in January 2009, the CFTC issued an omnibus order to investigate a number of suspected Ponzi-schemes and other types of fraud relating to pooled and managed investment vehicles. That order was initially approved for a 3 month period, and the CFTC subsequently re-issued it for several additional 6 month periods of time.

Following enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the CFTC unanimously approved a 6 month omnibus order on November 15, 2011 covering unlawful retail commodity transactions in response to a proliferation of precious metals-related schemes. The CFTC has periodically and unanimously re-issued that order for 6 month periods of time. In re-

sponse to patterns of illegal activity in certain areas, the CFTC also has approved time-limited omnibus orders to investigate, among other things, deceptive advertising related to forex accounts, customer segregation and minimum net capital requirements, and exchanges-for-related-positions.

Since I joined the CFTC in October 2011, the CFTC has approved five omnibus orders through ten individual votes to either initially issue or re-issue existing omnibus orders. Of those votes, only one did not enjoy bipartisan support, and only two were not unanimous votes of the Commission. During that same timeframe, dozens of formal orders of investigation have been approved in response to requests by the CFTC's Division of Enforcement.

The policy rationale for authorizing omnibus orders in limited circumstances is the need for the CFTC's staff to respond rapidly to suspected fraud and market abuses. In certain circumstances, for example in cases involving fraud on retail customers, evidence might be particularly prone to disappear quickly. Moreover, as noted in the excerpted response below, omnibus orders often permit the CFTC's Division of Enforcement to freeze assets belonging to customers, preserve books and records, or coordinate the expedited filing of related actions in cooperation with other civil or criminal authorities.

But there remain important limits on the authority provided by an omnibus order. The CFTC's orders authorizing the issuance of subpoenas can be used only during the course of the subject investigation. The CFTC's staff may issue subpoenas in a matter "covered" by an approved CFTC order until the Division of Enforcement concludes the investigation, and the CFTC may amend or withdraw an omnibus order at any time prior to the approved expiration of the order.

Please also see the following description of the CFTC's investigative authority prepared by the CFTC's Office of General Counsel in consultation with the CFTC's Division of Enforcement:

> The Commission's Division of Enforcement has the delegated authority to conduct investigations of suspected or alleged violations of the Commodity Exchange Act and Commission Regulations. The Division of Enforcement has broad powers to conduct such investigations. These investigative powers include obtaining evidence through voluntary statements and submissions, and inspections of boards of trade, reporting traders, and persons required by law to register with the Commission. If enforcement staff believes that it is necessary to compel testimony or the production of documents, it may request, pursuant to Commission regulation 11.4, that the Commission issue an order authorizing issuance of subpoenas, which provides staff with the authority to issue administrative subpoenas to compel production of records and/or testimony. These Commission orders are generally referred to as formal orders of investigation.
>
> Commission orders authorizing issuance of subpoenas provide a general description of the scope of the investigation, the authority under which the investigation is being conducted, and designates the individuals authorized to issue subpoenas. The scope of the investigation subject to such an order may be directed at compelling information and testimony concerning a particular entity's course of conduct or to a particular subject matter area.
>
> Authorization to issue subpoenas directed at a particular subject area is commonly referred to as an omnibus formal order. For example, the Commission has issued omnibus orders in response to the number of swindles targeting the retail public through the use of Ponzi schemes. At times, CFTC investigations require quick enforcement action to freeze assets belonging to customers, preserve books and records and, sometimes, coordinate the expedited filing of related actions in cooperation with other civil or criminal authorities. The Commission's omnibus formal orders have been instrumental in meeting these compressed timelines, particularly in cases involving ongoing fraud. Similarly, in other cases, access to omnibus subpoena authority has allowed the Division to expeditiously proceed with investigations and conserve resources by eliminating the need to draft and submit for Commission approval separate formal orders for each entity subject to investigation of the same subject matter. The omnibus order will be attached to new matters ("covered matters") that involve the same subject matter or violation.
>
> With respect to permissible time periods, Commission orders authorizing issuance of subpoenas can be used during the course of the subject investigation. What this means is that once an order is approved by the Commission, including so-called omnibus orders, staff may issue subpoenas in the covered matter until the Division concludes the investigation, unless otherwise ordered by the Commission. Separately, in certain omnibus orders the Commission has specified a time period during which the Division of Enforcement can attach

new covered matters. Those omnibus orders have also required that the Division of identify and report to the Commission with specificity all of the covered matters attached to the omnibus order.

In comparison to the Commission's approach of using targeted and time-limited omnibus formal orders, several other agencies have made complete, unencumbered delegations of subpoena authority to their staff. Such delegations of authority have been made by the: U.S. Securities and Exchange Commission; Civil Divisions of the Department of Justice and U.S. Attorneys offices; Federal Trade Commission; and United States Department of Agriculture, Packers and Stockyards Division.

Question 7. What is the legal justification for the Commission issuing a final "exemptive order" without prior notice-and-comment periods? Does this place Commission actions on questionable legal ground from a compliance standpoint with the Administrative Procedures Act?

Answer. The legal justification for issuing a final exemptive order without prior notice and comment provided by the CFTC's Office of General Counsel is as follows:

> The APA empowers an agency to proceed without notice and comment for good cause. *See* 5 U.S.C. § 553. The Commission has interpreted CEA Section 4(c), which authorizes the Commission to grant exemptive relief, to incorporate the APA's requirements, including the good cause exception. The Commission's view is that Congress did not intend that the Commission can *impose* requirements on market participants *without* notice and comment when there is good cause, but may not *exempt* market participants when the public interest dictates, or other good cause exists, without first allowing a comment period.

In addition, the preambles of CFTC rules and orders provide the legal rationale for the CFTC's regulatory actions and, where appropriate, how those actions comply with the APA. For example, since joining the CFTC, I have supported two CFTC actions that became effective prior to the completion of the notice-and-comment periods set forth in the interim final rule and order, respectively. In both cases, the CFTC provided a legal rationale and sought to address exigent circumstances that it believed presented considerable challenges for certain market participants seeking to comply with applicable law. The CFTC was advised in each case that it was acting consistent with statutory requirements under the CEA and APA.

For these reasons, and because relief was being provided through the CFTC action (rather than new or additional compliance burdens), I voted in favor of these interim actions.

Question 8. After the "*post hoc*" comment period has closed for some exemptive orders, will the Commission allow revisions to be made based on issues raised by the public comments?

Answer. The CFTC is carefully considering public comments and remains open to revisions, as appropriate. The CFTC's Office of General Counsel advises that "[i]n its informed discretion, the Commission may vote to allow such revisions."

Question 9. Are there written rules or policy guidelines on how the CFTC is to use the "no action" letter process? If not, does the Administrative Procedures Act govern the use or issuance of staff "no action" letters?

Answer. Please see the following response prepared by the CFTC's Office of General Counsel:

> CFTC Rule 140.99 sets forth the parameters. It states that a CFTC staff no-action letter is "a written statement by the staff of a Division of the Commission or of the Office of the General Counsel that it will not recommend enforcement action to the Commission for failure to comply with a specific provision of the [CEA] or of a Commission rule, regulation or order if a proposed transaction is completed or a proposed activity is conducted by" the beneficiary of the letter. The Rule states that the no-action letter represents the views of the Division that issued it or the Office of General Counsel and does not bind the Commission—it binds only the issuing staff and not the Commission or other Commission staff. It states that only the beneficiary may rely on the letter. *See* 17 CFR 140.99(a)(2).
>
> The Rule also sets forth a host of requirements, including that the letter will be issued in response to proposed transactions only, and not completed transactions unless there are extraordinary circumstances. *Id.* § 140.99(b)(3). Staff also will not respond to no-action requests posing hypothetical questions. *Id.* The proposed beneficiary must be identified, *id.* § 140.99(b)(4), and additional specified information must be provided, *id.* § 140.99(c). For the complete set of

requirements, *see* 17 CFR § 140.99(c)–(d); *see also id.* § 140.99(e) (concerning the form of a staff response).

Customer Protection

Question 10a. Is the Commission's ability to perform adequate market surveillance critical to protecting futures and swaps customers?

Answer. Yes. The primary mission of the CFTC is to protect market users, consumers and the public at large from (1) fraud, manipulation, and other abusive practices, and (2) systemic risk, related derivatives that are subject to the Commodity Exchange Act, as well as foster open, transparent, competitive, and financially sound markets. Congress established the CFTC for these purposes, among others, in 1974. The CFTC's market-surveillance program is crucial to accomplishing that mission.

For additional information, please see the attached "Commodity Futures Trading Commission, President's Budget and Performance Plan for Fiscal Year 2014," * submitted to the Appropriations Committees in the U.S. House of Representatives and U.S. Senate in April 2013 for a further description of the CFTC's surveillance program and resource allocations.

Question 10b. Should the CFTC's "Customer Protection" fund be utilized to make needed improvements to the Commission's technological capabilities? Why or why not?

Answer. The CFTC continues to evaluate the funds necessary to support the whistleblower and investor education programs based upon, among other things, the actual number of tips received and resulting investigations. The CFTC anticipates a number of claims will be paid to eligible whistleblowers in the upcoming fiscal year, providing a basis for estimating future spending on such programs.

Please see a recent balance of the CFTC's Customer Protection Fund, below:

	FY 2013 Projected Actual $000	FY 2014 Estimate $000	FY 2015 Estimate $000
Budget Authority—Prior Year	100,040	100,000	100,000
Budget Authority—New Year	1,210	12,250	13,750
Total Budget Authority	**101,250**	**112,250**	**113,750**
Whistleblower Program	750	750	750
Whistleblower Awards	—	10,000	10,000
Customer Education Program	500	1,500	3,000
Total Planned Expenditures	**1,250**	**12,250**	**13,750**
Unobligated Balance	**100,000**	**100,000**	**100,000**

Although the present unobligated balance in the CFTC Customer Protection Fund could be sufficient to cover anticipated whistleblower complaints and investor outreach efforts, the present statutory and regulatory obligations relating to whistleblower compensation potentially could require the CFTC to seek to transfer or reprogram monies to cover any shortfalls resulting from reallocation of such funds to technology spending.

For additional information, please see the attached "Commodity Futures Trading Commission, President's Budget and Performance Plan for Fiscal Year 2014," * submitted to the Appropriations Committees in the U.S. House of Representatives and U.S. Senate in April 2013.

Question 11. In light of the automated account verification system recently implemented by NFA and CME, does the CFTC still need read-only access to all Futures Commission Merchant customer fund accounts?

Answer. The CFTC continues to consider whether read-only access is necessary in light of recent NFA and CME customer-protection initiatives and the CFTC's recent proposed rulemaking. *See* 77 FED. REG. 67866, *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations; Proposed Rule* (Nov. 14, 2012) (seeking comment on the following questions concerning read-only access: What technology issues are raised by the Commission's proposal? How can the Commission adequately address such technology issues? What account information can depositories currently provide

* The document referred to is retained in Committee file, and can be accessed on the CFTC's website at: *http://www.cftc.gov/ssLINK/cftcbudget2014*.

to the Commission and to DSROs via the Internet on a read-only basis? Do all depositories (*e.g.,* banks, trust companies, derivatives clearing organizations, or other FCMs) have the capability of using the Internet to provide account access to the Commission and DSROs? Are there other options for depositories to provide read-only access to FCM accounts other than the Internet? How should the Commission implement this requirement? What timeframe would be appropriate to make the requirement effective?). The CFTC is carefully considering public comments on read-only access to FCM accounts and remains open to revising the customer protection proposal, as appropriate.

Question 12. Is reliance on the automated verification system utilized by CME and NFA a more secure method of accomplishing the same ultimate goal of protecting the integrity of customer funds?

Answer. The automated verification system utilized by CME and NFA is operated and maintained by a third-party with whom the CFTC does not have a contractual relationship. The CFTC is carefully considering public comments on read-only access to FCM accounts, as noted above, and remains open to revising its customer protection proposal, as appropriate. Depending on revisions to the final rules, the automated verification system could be a complementary or alternative means of protecting customers and ensuring compliance with applicable customer funds regulations.

Question 13. Do you think an exemption or some other form of protection should be made for small to medium-sized futures commission merchants pertaining to the level of excess margin required to be held under the CFTC's proposed customer protection rule?

Answer. The CFTC is carefully considering public comments on its excess margin requirements and remains open to revisions to its customer protection proposal, as appropriate. Any determination related to futures commission merchant margin requirements should take into account the competing interests of providing the appropriate protections for FCM customers and maintaining cost-effective access to the markets for those customers.

Question 14. I find it fascinating that with all of the publicity over the cross-border rules and Chairman Gensler's warnings about how a failure to regulate entities in other countries would "blow a hole in Title VII"—that the accounts of the small farmer, farm cooperatives, and the public municipalities were not protected. Why did any guidance on cross-border regulation not include a solution related to how customer accounts should be treated when a multi-national FCM, like MF Global Inc., goes bankrupt? Or do you need a legislative solution?

Answer. The CFTC's proposed customer protection rule is intended to provide greater protection to customers who trade on foreign markets through FCMs. First, the proposal would require an FCM to hold sufficient funds in segregated accounts to repay the full account balances of every customer trading on foreign markets (this would provide the customers with comparable protections to customers trading on CFTC designated contract markets). Second, the proposal would limit the amount of customer funds that an FCM may deposit with foreign depositories for trading on foreign markets to the amount of margin required on such foreign positions plus a 20 percent cushion. The 20 percent cushion is intended to provide a margin buffer to better ensure that an FCM has sufficient funds to meet daily margin obligations at foreign brokers and clearing organizations and acknowledges the time-zone differences that would prevent an FCM from doing real-time funding of foreign trading.

The CFTC is carefully considering public comments on its customer protections proposal and remains open to revisions, as appropriate.

End-User Issues

Question 15. In passing the Dodd-Frank Act, Congress made clear its intent to exempt end-users from bearing the additional financial and regulatory burdens brought on by the legislation. Keeping that intent in mind, why has the CFTC used such a low swap dealing threshold for Special Entities?

Answer. The CFTC sought to address Congressional concerns that pension plans, governmental investors, and charitable endowments were provided insufficient disclosures with respect to certain swaps and security-based swaps entered into with more sophisticated market participants. See Senate *Congressional Record* on July 15, 2010 at S5903–04. The Dodd-Frank Act, in fact, provided certain "special entities," defined in the Act, with additional protections from market practices that were viewed by some in Congress as increasing the risks faced by these entities in using swaps to manage financial risks. Accordingly, under the CFTC's final rules, persons dealing swaps to "special entities" must register as swap dealers if their dealing ac-

tivities individually exceed a sub-threshold of $25 million of aggregate gross notional value in a particular 1 year period.

Currently, the Commission is considering a petition from certain electric public utility providers seeking to be excluded from the special entity *de minimis* threshold based upon liquidity and other concerns. In the interim, the CFTC's staff has issued no-action relief increasing the registration threshold for entities dealing to utility special entities, subject to certain conditions. However, please note that the term "special entity" is defined in Section 4s(h)(2)(C) of the Commodity Exchange Act as a Federal agency; a State, State agency, city, county, municipality, or other political subdivision of a State; an employee benefit plan; a governmental plan; or an endowment, including an endowment. See 77 *Fed. Reg.* 30708 (May 23, 2012).

Question 16. Why do you think the Commission failed to completely exclude commercial end-users from regulation even after Congress made clear its intentions were not to regulate end-users who use swaps to hedge or mitigate risks from their business?

Answer. It is clear that in the Dodd-Frank Act, Congress intended to protect the risk-management activities of commercial firms. Since I joined the CFTC, the CFTC has proposed or finalized rules that, among other things, exempt agricultural and other end-users from the Dodd-Frank Act's clearing mandate, prevent certain inter-affiliate swaps from having to be cleared, and exclude non-financial end-users from having to post margin on uncleared swaps. *See, e.g., End-User Exception to the Clearing Requirement for Swaps,* 77 FED. REG. 42559 (July 19, 2012); *Clearing Exemption for Swaps Between Certain Affiliated Entities,* 78 FED. REG. 21749 (Apr. 11, 2013); *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants: Proposed Rule,* 76 FED. REG. 23732 (Apr. 28, 2011). In addition, the entities definitions rule in appropriate cases excludes hedging from those activities that could trigger registration, and the product definitions rule excludes from the term "swap" a number of instruments used and relied upon by the end-user community to manage risk. *See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant,"* 77 FED. REG. 30596 (May 23, 2012); *see also Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement record-keeping,* 77 FED. REG. 48207 (August 13, 2012).

Rulemaking, like legislating, requires balancing competing interests. On occasion, there is tension between the regulatory interests embodied in the Dodd-Frank Act itself, such as when steps to reduce the overall risk in the financial system may decrease liquidity and thus make it more difficult for some commercial end-users to manage their risks. Other times, the legitimate interests of different types of market participants are in conflict.

It is incumbent upon the CFTC to consider thoughtfully the interests affected by, and the consequences of, the policies that we adopt. Since I joined the commission, I believe the CFTC's rules have been informed by an ongoing dialogue with members of the end-user community, some of whom have issues that are relatively new to the CFTC and its staff. As a result, the CFTC must, and I intend to, continue to constructively engage with end-users to gain a sufficient understanding of how their trading activities are impacted by the CFTC's rules.

Question 17. Do you agree that forward contracts containing terms providing some form of flexibility in delivered commodity volumes—otherwise known as "volumetric optionality"—should fall underneath the scope of the forward-contract exclusion? Why or why not?

Answer. Forward contracts with embedded volumetric optionality serve an important risk-management function for commercial end-users. On July 10, 2012, the CFTC adopted an interim-final rule defining "swap" that provided further guidance concerning forwards with embedded volumetric optionality. Under the CFTC's interpretation, volumetric options meeting a seven-part test may qualify for the forward contract exclusion from the term "swap."

During consideration of this rule, I expressed concerns that the seven-factor test could unnecessarily complicate commercial practices that Congress did not intend to bring under the umbrella of the Dodd-Frank Act. In response to my concerns, the interim-final rule sought additional public comment on the seven-part-test. The CFTC is presently considering public comments and assessing whether changes to the CFTC's guidance should be proposed in the near future.

Question 18. The definition of "financial entity" in the Commodity Exchange Act cross-references the banking laws and depends on whether someone is engaged in activity that is "financial in nature." In short, this definition has the potential to treat many end-users like hedge funds in certain circumstances. Has the CFTC pro-

vided any guidance for how the banking definition of activities that are "financial in nature" applies in the context of Title VII for end-users? Is this something that Congress should address legislatively?

Answer. Congress defined "financial entity" in CEA section 2(h)(7)(C) in part by referring to two provisions that appear in the banking laws. Specifically, the definition refers to "a person predominantly engaged in activities that are in the business of banking," a term of art found in the National Bank Act that is within the jurisdiction of the Office of the Comptroller of the Currency ("OCC"), "or in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956," which is within the jurisdiction of the Board of Governors of the Federal Reserve System ("Federal Reserve").

As noted in the CFTC's final rule regarding the End-User Exception to the Clearing Requirement for Swaps, 77 *Fed. Reg.* 42559 (July 19, 2012), these provisions are subject to interpretation by the OCC and the Federal Reserve, respectively. Indeed, the CFTC referred to such an interpretation in footnote 12 of CFTC Letter No. 13–22 dated June 4, 2013, stating that for the purpose of such letter, market participants may look to the Federal Reserve's final rule defining "Predominantly Engaged In Financial Activities," 78 *Fed. Reg.* 20756 (Apr. 5, 2013), in determining whether they are "predominantly engaged in financial activities." As with any request from the public for guidance, the CFTC should thoughtfully consider and respond where appropriate to any request from a market participant who seeks guidance on whether they fall under the definition of "financial entity."

Question 19. Non-deliverable forwards (NDFs) were not included when the Treasury exempted foreign exchange swaps and forwards, under its authority under the Dodd-Frank Act, resulting in unnecessary and costly regulation. Do you believe the CFTC has the authority to address this unintended consequence by issuing an exemption providing that NDFs be treated the same as foreign exchange swaps and forwards? Should Congress clarify its intent to include NDFs in the definition of "foreign exchange forward"?

Answer. The CEA, as amended by Title VII of the Dodd-Frank Act, authorizes the Secretary of the U.S. Department of the Treasury to issue a written determination that foreign exchange swaps, foreign exchange forwards, or both, should not be regulated as "swaps" under the CEA. Pursuant to that authority, the Secretary issued a final determination that exempts both foreign exchange swaps and foreign exchange forwards from certain regulations applicable to "swaps." *See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, Final Determination,* 77 FED. REG. 224 (Nov. 20, 2012). The Secretary's final determination acknowledged that this authority was constrained by the CEA's definition of foreign exchange swaps and forwards, which by statute must involve the "exchange of 2 different currencies."

In addition, on August 13, 2012, the CFTC published the final rule providing guidance on the scope of and further defining the term "swap." *See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement record-keeping,* 77 FED. REG. 48207 (Aug. 13, 2012). In that release, the CFTC stated the following:

> NDFs are not expressly enumerated in the swap definition, but . . . they satisfy clause (A)(iii) of the swap definition because they provide for a future (executory) payment based on an exchange rate, which is an "interest or other rate[]" within the meaning of clause (A)(iii). Each party to an NDF transfers to its counterparty the risk of the exchange rate moving against the counterparty, thus satisfying the requirement that there be a transfer of financial risk associated with a future change in rate. This financial risk transfer in the context of an NDF is not accompanied by a transfer of an ownership interest in any asset or liability. Thus, an NDF is a swap under clause (A)(iii) of the swap definition.

Id at 48254–55. The CFTC also noted that "at least some market participants view NDFs as swaps today, and thus NDFs also may fall within clause (A)(iv) of the swap definition as 'an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." *Id. See also* CEA section 1a(47)(A)(iv) of the CEA, 7 U.S.C. 1a(47)(A)(iv).

The CFTC has not to date, however, subjected NDFs to a mandatory clearing determination. As such, market participants that utilize NDFs are not subject to certain regulatory obligations that otherwise would accompany a mandatory clearing determination.

In its final rulemaking, the CFTC also noted that one "commenter's request that the CFTC exempt NDFs from the swap definition using its exemptive authority under section 4(c) of the CEA, 7 U.S.C. 6(c) . . . with respect to NDFs, is beyond

the scope of this rulemaking." *Id.* at 48256. Based on CEA section 4(c), which provides the CFTC with exemptive authority, it is unclear whether the CFTC has the authority to issue an exemption providing that NDFs be treated the same as foreign exchange swaps and forwards.

Question 20. The CFTC requirement to record phone conversations at grain elevators that occasionally take orders from farmers who want to hedge in the futures market has been an issue of concerned raised by numerous commercial end-users. Based on your understanding, was this requirement called for by the Dodd-Frank Act? If not, why did the CFTC propose such a measure? What level of data should be collected at grain elevators, if any? How could this data collection be required in a manner that is not overly burdensome and costly to this sector of the marketplace?

Answer. There is no specific CFTC requirement for telephone conversations to be recorded at grain elevators that occasionally take orders from farmers who want to hedge in the futures market. CFTC Rule 1.35(a), as proposed, would have required members of a designated contract market ("DCM") or swap execution facility ("SEF") to record all oral communications that lead to the execution of a transaction in a cash commodity. The CFTC received numerous comments about the effect of such a requirement on members of the agricultural community that trade in cash commodities and are not required to be registered with the CFTC other than, in some cases, as floor traders. In response to those comments, the CFTC adopted modifications designed to preserve the rule's purpose without adversely affecting the agricultural community.

Accordingly, only those oral communications that lead to a transaction in a commodity interest (*i.e.,* a commodity futures contract, commodity option contract, foreign exchange contract, or swap) will have to be recorded. Furthermore, only futures commission merchants, certain introducing brokers, retail foreign exchange dealers, and those members of a DCM or SEF who are registered or required to be registered with the CFTC (except for floor traders, commodity pool operators, swap dealers, major swap participants, and floor brokers who trade for themselves) will have to record oral communications. To the extent a grain elevator is required to record its oral communications, that requirement only arises because of its registration status and the type of transactions it is entering into, namely commodity-interest transactions. CFTC Rule 1.35(a) was amended in this way to conform it to the recordkeeping requirements for swap dealers and major swap participants that were required under new Section 4s of the Commodity Exchange Act and Part 23 of the Commission's Regulations.

Swap Dealer Definition

Question 21. Would excluding SEF-executed trades from the *de minimis* calculation help achieve Dodd-Frank's goals of encouraging trading on SEF's and requiring clearing?

Answer. Excluding SEF-executed trades from the *de minimis* calculation would seem to incentivize market participants to trade on SEFs, absent other countervailing market or commercial considerations. However, in its rulemaking defining "swap dealers," the CFTC determined that exempting all such trading activity would be potentially inconsistent with Congress' intent in requiring registration and regulation of persons engaging more than a *de minimis* amount of swap dealing activity. The inclusion of a particular trade in the *de minimis* calculation for purposes of determining whether a person must register as a "swap dealer" depends not on the venue in which the transaction occurs but on the nature of the activity. Trading, speculative, and hedging activities in many cases do not count towards the *de minimis* calculation whether or not they are conducted on a regulated platform.

Position Limits

Question 22. As you know, a properly functioning positions limit regime is not only dependent on a clear understanding of deliverable supply for a particular commodity, but also on a workable hedge exemption process. In a stark change from historical practice, the CFTC's approach in its since-vacated position limits rule was to limit the availability of the *bona fide* hedge exemption to only a few specific types of transactions. The result was a hedge exemption that was nearly unworkable. Why did the Commission deviate from the Commission's well-functioning historical approach, and does the Commission plan on providing a more flexible hedge exemption in its forthcoming proposed rule?

Answer. The referenced CFTC final rule and interim final rule for "Position Limits on Futures and Swaps," 76 *Fed. Reg.* 71626 (Nov. 18, 2011), was adopted by the CFTC prior to my confirmation. The CFTC is presently considering a re-proposal of

that final rule and is seeking comment on all aspects of the re-proposal, including the scope and availability of enumerated and non-enumerated hedge exemptions.

The CFTC will carefully consider public comments on this aspect of the re-proposal with the goal of adopting a workable position limits regime that protects legitimate hedging activities and prevents excessive speculation in subject commodities.

Question 23. Should Congress be more explicit in defining what exactly constitutes a "*bona fide* hedge"?

Answer. Definitions of "hedging" and "*bona fide* hedging" must be tailored to their particular regulatory purposes. A single statutory definition of "hedging" or "*bona fide*" hedging could be over-inclusive for certain purposes and under-inclusive for others. In the context of the end-user exception, for example, the CFTC gave effect to Congressional intent by merely requiring that swaps be "economically appropriate" to the reduction of commercial risk, which is broadly defined as including the risk of the potential change in value of assets, liabilities, or services, including change resulting from a change in interest rates, currency or FX movements, and including anticipated assets and liabilities. "Hedging or mitigating commercial risk" therefore broadly includes "*bona fide* hedging" and any position that counts as a hedge for accounting purposes, for example.

However, in the position limits context, this conceptualization and broad definition of "hedging" could actually undermine Congressional objectives to curb excessive speculation in energy markets. The CFTC has previously stated its view that Congress intended the use of the term "*bona fide* hedging" in this context to set forth a relatively narrow exclusion from "speculative" positions that generally contemplates a substitute for transactions or positions (interpreted as physical positions) taken or intended to be taken in the future.

Question Submitted By Hon. Doug LaMalfa, a Representative in Congress from California

Question. Some have suggested that the way to "fix" the special entity sub-threshold is for the CFTC to lower the *de minimis* registration threshold for the *entire* energy swaps marketplace to $25 million. What damage would be done to end-users, consumers, and the marketplace by lowering the registration threshold for all energy swaps to $25 million?

Answer. As discussed in response to *Question 15,* above, the CFTC sought to address Congressional concerns that pension plans, governmental investors, and charitable endowments were provided insufficient disclosures with respect to certain swaps and security-based swaps entered into with more sophisticated market participants. *See* Senate *Congressional Record* on July 15, 2010 at S5903–04. The Dodd-Frank Act, in fact, provided certain "special entities," defined in the Act, with additional protections from market practices that were viewed by some in Congress as increasing the risks faced by these entities in using swaps to manage financial risks. Accordingly, under the CFTC's final rules, persons dealing swaps to "special entities" must register as swap dealers if their dealing activities individually exceed a sub-threshold of $25 million of aggregate gross notional value in a particular 1 year period.

These regulatory interests, and the Congressional intent behind creation of the "special entities" category, may not be applicable to other types of entities operating in or relying upon the swaps market. However, in determining the appropriate *de minimis* threshold for all dealing entities, and in setting forth guidance on the types of trading activities that constitute dealing activities in the first instance, the CFTC balanced the needs of commercial end-users and energy firms against the regulatory objectives achieved through registration and regulation of dealing entities.

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