United States Senate
Committee on Agriculture, Nutrition, & Forestry
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Intro

Chairman Roberts, Ranking Member Stabenow, and Members of the Committee, thank you for the opportunity to testify about the reauthorization of the Commodity Futures Trading Commission (CFTC), and the state of derivative markets.

I am the President and Chief Executive Officer of FIA. FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Brussels, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, law firms and other professionals serving the industry.

FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and to promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members help reduce systemic risk in global financial markets. Equally important, our clearing firm members provide access to the commodity futures markets, which allows a wide range of companies in the commodity supply chain to manage their price risks.

Prior to serving as the President and CEO of FIA, I had the honor of serving as a Commissioner of the CFTC from August 2002 to June 2009. During that time, I served as the Acting Chairman from June 2007 to January 2009.

The CFTC was last reauthorized in 2008 as part of the Farm Bill. At that time, I was serving as Acting Chair of the CFTC. It was a privilege to work with my fellow Commissioners and the members and staff of this Committee to ensure the agency had the regulatory and enforcement tools necessary to continue to effectively oversee the markets.

Prior to 2008, the CFTC was last reauthorized in December 2000, as a part of the Commodity Futures Modernization Act of 2000. At that time, I had the privilege of serving as a professional staff member for this Committee under the leadership of the late Chairman Richard Lugar.

This varied experience has provided me a firsthand understanding of the importance of the CFTC reauthorization process because it provides a Congressional stamp of approval on this agency's important mission and legal authority. Today, I am honored in my current capacity to once again work with this Committee as you deliberate reauthorization and possible changes to the Commodity Exchange Act (CEA).

Market Trends

Markets Have Grown Significantly

In the decade since the last reauthorization in 2008, our markets have grown significantly with volume of futures and options increasing 70 percent over this time. Today there are more products and participants using these markets to hedge and manage risk than ever before. Demand for these risk-management products remain high.

Markets Are Safer

Thanks to the implementation of the post-crisis reforms to the OTC derivatives markets, a large percentage of interest rate and credit default swaps are now submitted to central counterparties for clearing. According to CFTC data, 90 percent of interest rate swaps and 62 percent of credit derivatives are now cleared, respectively. This reduces the amount of risk in these markets and provides greater transparency for both regulators and market participants.

Markets Are Increasingly Global

Since the last reauthorization, our markets have become much more global. The CFTC first allowed U.S. customers direct electronic access to foreign exchanges in 1996, and today all major exchanges in the U.S. and abroad have anywhere from one-third to ninety percent of their volumes coming from outside their home location. Importantly, these transactions from foreign participants add important liquidity to a market that keeps costs affordable for domestic customers hedging risk.

Technology Has Transformed Markets

Like most economic sectors, this industry has been transformed by technology, whether it's the way market participants trade futures, the way trades are processed and cleared, or the way regulators surveil the markets. Technology has provided the markets with greater efficiencies that enable more people to access these products globally at significantly lower costs.

FIA Views on CFTC Reauthorization

Preserve Flexible Core Principles

To keep pace with technological advances and changing market dynamics, FIA supports the CFTC's existing principles-based approach to regulation, which has served the agency well for the past twenty years. The core principles of the CEA provide the CFTC with outcomes-based tools that can be tailored to an ever-changing global marketplace driven by technology. It allows the agency to focus on the risk of activities across a broad array of market participants and products. This Committee has equipped the CFTC with these important tools that have allowed the agency to evolve with changing market dynamics, and this flexibility should be preserved.

Maintain Access to the Global Markets

Earlier this month, this Committee held a hearing titled "Certainty in Global Markets for the U.S. Agriculture Sector." As producers need access to global commodity markets to sell their physical commodities, they too need access to global derivatives markets to hedge risk in times of uncertainty. Knowing that they can rely on well-regulated futures and options markets gives American farmers the protection from price volatility that they need to compete in the global markets for corn, wheat and soybeans.

The reverse is also true: companies all over the world use the agricultural and energy contracts listed on U.S. futures markets as the benchmarks for global trade in these commodities. That brings additional liquidity to these markets, and that is a win-win for customers here in the U.S.

FIA, however, is closely monitoring several areas of concern that could impact access to European and U.S. markets as the Brexit debate continues. Recent revisions to the European Market Infrastructure Regulation legislation (EMIR 2.2) on clearinghouse supervision may require direct compliance with substantial elements of EU law and supervision by EU regulators for U.S. clearinghouses deemed systemic unless EU regulators find U.S. supervision equivalent. If implemented without the proper recognition of home country supervision, this could lead to contradictory requirements, duplicative supervision and counter-reactions by global regulatory authorities. These EU consultations, which are currently out for public comment, may impact access to global markets if not properly clarified and implemented. The current Chairman of the CFTC has also announced his intention to strengthen the CFTC's ability to recognize and defer to home country supervision for foreign CCPs. FIA stands ready to comment on all these proposals to ensure the proven regulatory deference and recognition approach remains the standard for cross-border regulation.

Regulatory Harmonization

In today's markets, there is an increased need for harmonization amongst regulators both domestic and global. With firms conducting more cross-border transactions and more cross-asset trading strategies, CFTC, SEC, and global regulators will need greater coordination when it comes to information sharing and approaches to market oversight. Markets function effectively and with less disruption when the rules of engagement are clear, simple and transparent. At a time when U.S. firms are facing regulatory fragmentation both domestically and abroad, we should encourage regulators within the U.S. and abroad to work together to harmonize rules and frameworks.

Customer Protection

FIA joins the National Futures Association (NFA) in supporting legislative clarification to resolve legal uncertainty in futures commission merchant bankruptcies as to the definition of "customer property" created by a bankruptcy court decision in the Griffin Trading case. The sanctity of segregated customer funds remains an important tenet of the CFTC's customer protection regime and FIA stands ready to assist the Committee on this clarification.

Cybersecurity and Data

In May 2019, CFTC Chairman Christopher Giancarlo testified before the Senate Appropriations Subcommittee on Financial Services and General Government that the CFTC faces 200,000 separate cyber-attacks per month. In June 2019, the CFTC Inspector General published a report that the agency has "numerous weaknesses" in the way it stores data used to regulate the markets.

FIA supports providing the CFTC with the resources, authority and direction to review and enhance their data collection methods and practices given the sensitivity of the data collected and the potential for unauthorized access. This includes reviewing whether there is duplicative or unnecessary collection of data taking place and how data collected by the agency is being retained. Further, we support efforts to amend the CEA to ensure that data housed by the CFTC is encrypted and confidential. In addition, FIA believes that highly sensitive source code data developed by firms to run their trading systems deserves the same protections under the law as any other form of intellectual property.

FIA Supports Efforts to Modernize the CFTC

The last CFTC Reauthorization was enacted the same year Apple launched its App Store. The technology advancements by market participants since that time has been incredible.

FIA commends CFTC Chairman Giancarlo for the agency's LabCFTC initiative to promote financial technology (fintech) innovation and encourages his successor to continue this forward-thinking approach.

Unfortunately, it has been a challenge for the CFTC to keep pace with the technology developments. According to the Chairman of the CFTC, "The CFTC lacks the legal authority to partner and collaborate with outside entities engaging directly with fintech within a research and testing environment, including when the CFTC receives something of value absent a formal procurement."[1]

FIA supports efforts to improve the research and development capabilities of the CFTC. This includes legislative efforts, such as those led by Representative Austin Scott (R-GA), that would provide the CFTC transaction authority to engage in public-private partnerships with financial technology developers. NASA, the Department of Defense, and other federal agencies already have this type of authority. This authority would assist the CFTC so it can fully vet and test potential rules and regulations on the technology being utilized by industry.

Crypto-Assets

As you know, several CFTC-regulated trading venues have introduced futures and options based on the value of Bitcoin, and several more venues are preparing to come to market. FIA is a strong supporter of innovation and competition in markets, but we also believe that the introduction of these products may create risks that should be carefully reviewed and thoroughly discussed by all industry stakeholders who may share in the risk of a default. We stand ready to engage with Members of this Committee on any specific proposals that may be considered related to emerging crypto-assets and the derivatives markets.

Impact of Capital on Client Clearing

Although the CFTC was last reauthorized in 2008, the CEA underwent significant changes when, under the Dodd-Frank Act, Congress determined to extend clearing beyond futures to swaps. As such, the role of the futures commission merchants (FCMs) has also expanded.

The new clearing mandates of Dodd-Frank sought to mitigate systemic financial risk by increasing central clearing. FIA supports that goal because central clearing serves as a highly effective safety mechanism for the futures, options and now swaps markets. As an industry, we have made great progress in our efforts to increase central clearing. According to remarks earlier this year from Dietrich Domanski, Secretary General of Financial Stability Board, "in 2009, the clearing level was around 24% for interest rate derivatives and just 5% for credit derivatives. By June 2018 these levels had risen to approximately 62% for interest rate derivatives and 37% for credit derivatives. Today, 90% of new OTC single currency interest rate derivatives are now centrally cleared in the U.S."[2]

[1] https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo66
[2] https://www.fsb.org/wp-content/uploads/S270219.pdf

From a public policy perspective, one of the great benefits of central clearing is that it provides protections from systemic risk that are borne by the market participants and not by taxpayers. According to CCP12, a global association of central counterparties, the total amount of initial margin held at clearinghouses worldwide was $702.46 billion at the end of last year. In effect, this is the money that market participants have posted as protection against losses arising from adverse movements in the markets. This is the first line of defense for a systemic type of default. Second, there are additional funds deposited by the industry in clearinghouse default funds that serve as a further backstop to the clearing system and safety mechanism.

These are positive trends, but there is a worrisome trend in the number of clearing firms that support this global network of clearinghouses. According to CFTC data, the number of firms providing clearing services for customers in the U.S. futures markets dropped from 84 in 2008 to 55 in 2018. There are even fewer firms providing clearing services for swaps. When mandatory clearing for swaps took effect in 2014, there were 22. Now there are only 17. This decline in the number of clearing firms results in fewer choices for customers and greater concentration of risk. This is concerning and should be considered by Congress as it evaluates any reforms to the CEA.

There are many reasons for this decline in the number of clearing firms. Consolidation, advances in technology, the low interest rate environment and the evolution of markets to more global in nature have all played a role in this decline. But it is also important to recognize unintended consequences of Basel III, which is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis that have contributed to clearing firms making the decision to exit the business.

One of the central elements of post-crisis reforms was to increase the amount of capital supporting the banking system. Unfortunately, the central banks that developed Basel III did not consider the potential impact on client clearing. In contrast to the type of risk-taking activities that led to the financial crisis of 2008, client clearing is a relatively low risk service that some banks provide to their clients. To ensure that it remains low risk, these banks require clients to provide collateral to cover their margin requirements.

Any margin paid to a clearing member from a customer for cleared derivatives transactions is legally considered to belong to the customer. This margin must be segregated from the bank's own funds. The clearing member cannot use segregated client margin in any circumstance. Yet under the current rules, there is no recognition for the initial margin under the supplemental leverage ratio (SLR) and very limited recognition under the risk weight assets (RWA) capital requirements.

Under the capital requirements implemented by the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), banks are required to set aside a considerable amount of capital for client clearing activity. In effect, this is creating a powerful disincentive for banks to provide this service to their customers. It is also in direct conflict with the clearing mandates mandated by Dodd-Frank.

FIA strongly believes that this capital charge needs to be recalibrated so that it reflects the true amount of risk in this activity. We are encouraged to learn that last week the Basel Committee on Banking Supervision agreed on providing client initial margin to offset the exposure amounts under the leverage ratio. We look forward to the U.S. prudential regulators implementing this global revision.

The U.S. prudential regulators are currently consulting on a rulemaking related to the methodology used to calculate the capital rules. This proposed methodology—called the standardized approach for counterparty credit risk (SA-CCR)—must be recalibrated to ensure that banks are not discouraged from providing this essential service, as mandated by Dodd-Frank. FIA thanks the current Commissioners of the CFTC for their leadership on this issue, and for their recent bipartisan comment letter to the prudential regulators calling for a recalibration of the SLR calculation that allows initial margin to offset potential future exposures. FIA agrees with the current Commissioners that this would remove an unnecessary obstacle to banks offering client clearing services, consistent with G20 mandates and Dodd-Frank. Beyond better recognition of the exposure reducing initial margin, we encourage the Committee to consider other necessary changes to the proposed rule that will have a negative impact on clearing, especially for commercial end-users.

Conclusion

I am fortunate to represent a wide array of stakeholders in the listed, cleared and regulated derivatives industry – all of whom want to see this industry continue to support the price discovery and risk management needs of their customers in a productive way. It is an honor to be with you today and to work with this Committee as you craft a reauthorization of the CFTC and explore possible reforms to the Commodity Exchange Act (CEA) that strengthen our markets.