

Statement of Vincent McGonagle
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Before the Financial Institutions and Consumer Protection Subcommittee
Senate Committee on Banking, Housing, and Urban Affairs
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Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for the opportunity to appear before you today. I am Vincent McGonagle and I am the Director of the Division of Market Oversight of the Commodity Futures Trading Commission (CFTC).

Background on Commodity Exchange Act and the CFTC Mission

The purpose of the Commodity Exchange Act (CEA) is to serve the public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information. Consistent with its mission statement and statutory charge under the CEA, the CFTC is tasked with protecting market participants and the public from fraud, manipulation, abusive practices and systemic risk related to derivatives – both futures and swaps – and to foster transparent, open, competitive and financially sound markets. In carrying out its mission and statutory charge, and to promote market integrity, the Commission polices derivatives markets for various abuses and works to ensure the protection of customer funds. Further, the agency seeks to lower the risk of the futures and swaps markets to the economy and the public. To fulfill these roles, the Commission oversees designated contract markets (DCMs), swap execution facilities (SEFs), derivatives clearing organizations, swap data repositories, swap dealers, futures commission merchants, commodity pool operators and other intermediaries.

The CEA has for many years required that any futures transaction, unless subject to an exemption, be conducted on or subject to the rules of a board of trade which has been designated

by the CFTC as a DCM. Sections 5 and 6 of the CEA and Part 38 of the Commission's regulations provide the legal framework for the Commission to designate DCMs, along with each DCM's compliance requirements with respect to the trading of commodity futures contracts. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), DCMs were also permitted to list swap contracts. Along with this expansion of product lines that can be listed on DCMs, the Dodd-Frank Act also amended various substantive DCM requirements, under CEA Section 5, and adopted a new regulatory category for exchanges that provide for the trading of swaps (SEFs).¹ The Commission revised its DCM regulations to reflect these new requirements, and also adopted regulations to implement the Dodd-Frank Act's SEF requirements.

Under the CEA and the Commission's contract and rule review regulations, all new product terms and conditions, and subsequent associated amendments, are submitted to the Commission before implementation. In submitting new products and associated amendments, DCMs and SEFs are legally obligated to meet certain core principles; one of the most significant being the prohibition, in DCM and SEF Core Principle 3, on listing contracts that are readily susceptible to manipulation.² DCMs and SEFs self-certify most of their products to the

¹ In addition to the provisions regarding listing of swaps on DCMs and SEFs, the Dodd-Frank Act provides that, unless a clearing exception applies and is elected, a swap that is subject to a clearing requirement must be executed on a DCM, SEF, or SEF that is exempt from registration under CEA, unless no such DCM or SEF makes the swap available to trade.

² DCM and SEF Core Principle 3 states, "Contract Not Readily Subject to Manipulation—The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation."

Commission, as allowed under the CEA,³ and self-certified contracts may be listed for trading shortly after submission.⁴ The Commission has provided Guidance to DCMs and SEFs on meeting Core Principle 3 in Appendix C to Part 38 of the Commission's regulations. Failure of a DCM or SEF to adopt and maintain practices that adhere to these requirements may lead to the Commission's initiation of proceedings to secure compliance.

Among other things, a DCM or SEF that lists a contract that is settled by physical delivery should design its contracts in such a way as to avoid any impediments to the delivery of the commodity in order to promote convergence between the price of the futures contract and the cash market value of the commodity at the time of delivery. The specified terms and conditions considered as a whole should result in a deliverable supply that is sufficient to ensure that the contract is not susceptible to price manipulation or distortion.⁵ The contract terms and conditions should describe or define all of the economically significant characteristics or attributes of the commodity underlying the contract, including: quality standards that reflect those used in transactions in the commodity in normal cash marketing channels; delivery points at a location or locations where the underlying cash commodity is normally transacted or stored; conditions that delivery facility operators must meet in order to be eligible for delivery, including

³ For example, while contracts can be submitted for approval, of the almost 5,000 contracts submitted by DCMs and SEFs since the Dodd-Frank Act was enacted, all were submitted on a self-certification basis, and over 2,000 contracts were certified in calendar year 2013 alone.

⁴ A DCM or SEF need wait only one full business day after the contract has been submitted to list the contract for trading.

⁵ Deliverable supply means the quantity of the commodity meeting the contract's delivery specification that reasonably can be expected to be readily available to short traders and salable by long traders at its market value in normal cash marketing channels at the contract's delivery points during the specified delivery period, barring abnormal movement in interstate commerce.

considerations of the extent to which ownership of such facilities is concentrated and whether the level of concentration would render the futures contract susceptible to manipulation; delivery procedures that seek to minimize or eliminate any impediment to making or taking delivery by both deliverers and takers of delivery to help ensure convergence of cash and futures at the expiration of a futures delivery month.

Commission staff utilizes considerable discretion and can request that DCMs and SEFs provide full explanations of their compliance with the Commission's product requirements. Commission staff may ask a DCM or SEF at any time for a detailed justification of its continuing compliance with core principles, including information demonstrating that any contract certified to the Commission for listing on that exchange meets the requirements of the Act and DCM or SEF Core Principle 3.

Expansion of CFTC Enforcement Authority Under Dodd-Frank

The Commission's responsibilities under the CEA include mandates to prevent and deter fraud and manipulation. The Dodd-Frank Act enhanced the Commission's enforcement authority by expanding it to the swaps markets. The Commission adopted a rule to implement its new authorities to police against fraud and manipulative schemes. In the past, the CFTC had the ability to prosecute manipulation, but to prevail, it had to prove the specific intent of the accused to affect prices and the existence of an artificial price. Under the new law and rules implementing it, the Commission's anti-manipulation reach is extended to prohibit the reckless use of manipulative schemes. Specifically, Section 6(c)(3) of the CEA now makes it unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any

swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity. In addition, Section 4c(a) of the CEA now explicitly prohibits disruptive trading practices and the Commission has issued an Interpretive Guidance and Policy Statement on Disruptive Practices.⁶

In addition, the Dodd-Frank Act established a registration regime for any foreign board of trade (FBOT) and associated clearing organization who seeks to offer U.S. customers direct access to its electronic trading and order matching system. Applicants for FBOT registration must demonstrate, among other things, that they are subject to comprehensive supervision and regulation by the appropriate governmental authorities in their home country or countries that is comparable to the comprehensive supervision and regulation to which Commission-designated contract markets and registered derivatives clearing organizations are respectively subject.

CFTC Coordination with Foreign and Domestic Regulators

The Commission recognizes that commodity markets are international in nature and, accordingly, regularly consults with other countries' regulators. In particular, staff regularly consult with staff of the FCA (the LME's home regulatory authority) as to market conditions with respect to products of mutual interest, including the LME's recent introduction of warehouse reforms. The two agencies also participate in mutual information-sharing agreements for both market surveillance and enforcement purposes.

⁶ Antidisruptive Practices Authority, 78 FR 31890 (May 28, 2013), <http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2013-12365a.pdf>.

Similarly, the Commission formally and informally consults and coordinates with other domestic financial regulators. For example, the CFTC and the Federal Energy Regulatory Commission (FERC) have had a memorandum of understanding (MOU) in place since 2005 that provides for information exchange related to oversight or investigations. Earlier this month, FERC and the CFTC signed two Memoranda of Understanding (MOU) to address circumstances of overlapping jurisdiction and to share information in connection with market surveillance and investigations into potential market manipulation, fraud or abuse. The MOUs allow the agencies to promote effective and efficient regulation to protect the nation's energy markets and increased cooperation between the agencies.

Again, thank you for the opportunity to appear before the Subcommittee. I will be pleased to respond to any questions you may have.