Testimony of Chairman Timothy Massad before the U.S. Senate Committee on Banking, Housing, and Urban Affairs

Washington, DC

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Thank you Chairman Johnson, Ranking Member Crapo and members of the Committee. I am pleased to testify before you today on behalf of the Commission. This is my first official hearing as Chairman of the CFTC. It is truly an honor to serve as Chairman at this important time.

I met and spoke with several members of this Committee during the confirmation process, and I appreciated hearing your thoughts and suggestions during that time. I look forward to this Committee's input going forward.

During the last five years, we have made substantial progress in recovering from the worst financial crisis since the Great Depression. The Dodd-Frank Act was a comprehensive response, and much has been accomplished in implementing it. The CFTC has largely completed the rulemaking stage of Dodd-Frank implementation. However, much work remains to finish the job Congress has given us.

I look forward to working together with you, as well as my colleagues at the CFTC and others around the globe to ensure that our futures, swaps and options markets remain the most efficient and competitive in the world, and to protect the integrity of the markets.

The Significance of Derivatives Market Oversight

Very few Americans participate directly in the derivatives markets. Yet these markets profoundly affect the prices we all pay for food, energy, and most other goods and services we buy each day. They enable farmers to lock in a price for their crops, utility companies or airlines to hedge the costs of fuel, and auto companies or soda bottlers to know what aluminum will cost. They enable exporters to manage fluctuations in foreign currencies, and businesses of all types to lock in their borrowing costs. In the simplest terms, derivatives enable market participants to manage risk.

In normal times, these markets create substantial, but largely unseen, benefits for American families. During the financial crisis, however, they created just the opposite. It was during the financial crisis that many Americans first heard the word derivatives. That was because over-the-counter swaps – a large, unregulated part of these otherwise strong markets – accelerated and intensified the crisis like gasoline poured on a fire. The government was then required to take actions that today still stagger the imagination: for example, largely because of excessive swap risk, the government committed $182 billion to prevent the collapse of a single company – AIG – because its failure at that time, in those circumstances, could have caused our economy to fall into another Great Depression.

It is hard for most Americans to fathom how this could have happened. While derivatives were just one of many things that caused or contributed to the crisis, the structure of some of these products created significant risk in an economic downturn. In addition, the extensive, bilateral transactions between our largest banks and other institutions meant that trouble at one institution could cascade quickly through the financial system like a waterfall. And, the opaque nature of this market meant that regulators did not know what was going on or who was at risk.

Responding to the Crisis – Enactment and Implementation of the Dodd-Frank Act

The lessons of this tragedy were not lost on the leaders of the United States and the G-20 nations. They committed to bring the over-the-counter swaps market out of the shadows. They agreed to do four basic things: require regulatory oversight of the major market players; require clearing of standardized transactions through regulated clearinghouses known as central counterparties or CCPs; require more transparent trading of standardized transactions; and require regular reporting so that we have an accurate picture of what is going on in this market.

In the United States, these commitments were set forth in Title VII of the Dodd-Frank Act. Responsibility for implementing these commitments was given primarily to the CFTC. I would like to review where we stand in implementing the regulatory framework passed by Congress to bring the over-the-counter swaps market out of the shadows.

- **Oversight**

The first of the major directives Congress gave to the CFTC was to create a framework for the registration and regulation of swap dealers and major swap participants. The agency has done so. As of August 2014, there are 104 swap dealers and two major swap participants provisionally registered with the CFTC.

We have adopted rules requiring strong risk management. We will also be making periodic examinations to assess risk and compliance. The new framework requires registered swap dealers and major swap participants to comply with various business conduct requirements.

These include strong standards for documentation and confirmation of transactions, as well as dispute resolution processes. They include requirements to reduce risk of multiple transactions through what is known as portfolio reconciliation and portfolio compression. In addition, swap dealers are required to make sure their counterparties are eligible to enter into swaps, and to make appropriate disclosures to those counterparties of risks and conflicts of interest.

As directed by Congress, we have worked with the SEC, other US regulators, and our international counterparts to establish this framework. We will continue to work with them to achieve as much consistency as possible. We will also look to make sure these rules work to achieve their objectives, and fine-tune them as needed where they do not.

- **Clearing**

A second commitment of Dodd-Frank was to require clearing of standardized transactions at central counterparties. The use of CCPs in financial markets is commonplace and has been around for over one hundred years. The idea is simple: if many participants are trading standardized products on a regular basis, the tangled, hidden web created by thousands of private two-way trades can be replaced with a more transparent and orderly structure, like the spokes of a wheel, with the CCP at the center interacting with other market participants. The CCP monitors the overall risk and positions of each participant.

Clearing does not eliminate the risk that a counterparty to a trade will default, but it provides us various means to mitigate that risk. As the value of positions change, margin can be collected efficiently to ensure counterparties are able to fulfill their obligations to each other. And if a counterparty does default, there are tools available to transfer or unwind positions and protect other market participants. To work well, active, ongoing oversight is critical. We must be vigilant to ensure that CCPs are operated safely and deliver the benefits they are designed to provide.

The CFTC was the first of the G-20 nations' regulators to implement clearing mandates. We have required clearing for interest rate swaps (IRS) denominated in US dollars, Euros, Pounds and Yen, as well as credit default swaps (CDS) on certain North American and European indices. Based on CFTC analysis of data reported to swap data repositories, as of August 2014, measured by notional value, 60% of all outstanding transactions were cleared. This is compared to estimates by the International Swaps and Derivatives Association (ISDA) of only 16% in December 2007. With regard to index CDS, most new transactions are being cleared – 85% of notional value during the month of August.

Our rules for clearing swaps were patterned after the successful regulatory framework we have had in place for many years in the futures market. We do not require that clearing take place in the United States, even if the swap is in U.S. dollars and between U.S. persons. But we do require that clearing occurs through registered CCPs that meet certain standards – a comprehensive set of core principles that ensures each clearinghouse is appropriately managing the risk of its members, and monitoring its members for compliance with important rules.

Fourteen CCPs are registered with the CFTC as derivatives clearing organizations (DCOs) either for swaps, futures, or both. Five of those are organized outside of the United States, including three in Europe which have been registered since 2001 (LCH.Clearnet Ltd.); 2010 (ICE Clear Europe Ltd); and 2013 (LCH.Clearnet SA). In some cases, a majority of the trades cleared on these European-based DCOs are for U.S. persons.

At the same time, the CFTC has specifically exempted most commercial end-users from the clearing mandate. We have been sensitive to Congress's directive that these entities, which were not responsible for the crisis and rely on derivatives primarily to hedge commercial risks, should not bear undue burdens in accessing these markets to hedge their risk.

Of course, central clearing by itself is not a panacea. CCPs do not eliminate the risks inherent in the swaps market. We must therefore be vigilant. We must do all we can to ensure that CCPs have financial resources, risk management systems, settlement procedures, and all the necessary standards and safeguards consistent with the core principles to operate in a fair, transparent and efficient manner. We must also make sure that CCP contingency planning is sufficient.

- **Trading**

The third area for reform under Dodd-Frank was to require more transparent trading of standardized products. In the Dodd-Frank Act, Congress provided that certain swaps must be traded on a swap execution facility (SEF) or another regulated exchange. The Dodd Frank Act defined a SEF as "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants." The trading requirement was designed to facilitate a more open, transparent and competitive marketplace, benefiting commercial end-users seeking to lock in a price or hedge risk.

The CFTC finalized its rules for SEFs in June 2013. Twenty-two SEFs have temporarily registered with the CFTC, and two applications are pending. These SEFs are diverse, but each will be required to operate in accordance with the same core principles. These core principles provide a framework that includes obligations to establish and enforce rules, as well as policies and procedures that enable transparent and efficient trading. SEFs must make trading information publicly available, put into place system safeguards, and maintain financial, operational and managerial resources to discharge their responsibilities.

Trading on SEFs began in October of last year. Beginning February 2014, specified interest rate swaps and credit default swaps must be traded on a SEF or another regulated exchange. Notional value executed on SEFs has generally been in excess of $1.5 trillion weekly.

It is important to remember that trading of swaps on SEFs is still in its infancy. SEFs are still developing best practices under the new regulatory regime. The new technologies that SEF trading requires are likewise being refined. Additionally, other jurisdictions have not yet implemented trading mandates, which has slowed the development of cross-border platforms. There will be issues as SEF trading continues to mature. We will need to work through these to achieve fully the goals of efficiency and transparency SEFs are meant to provide.

- **Data Reporting**

The fourth Dodd-Frank reform commitment was to require ongoing reporting of swap activity. Having rules that require oversight, clearing, and transparent trading is not enough. We must have an accurate, ongoing picture of what is going on in the marketplace to achieve greater transparency and to address potential systemic risk.

Title VII of the Dodd-Frank Act assigns the responsibility for collecting and maintaining swap data to swap data repositories (SDRs), a new type of entity necessitated by these reforms. All swaps, whether cleared or uncleared, must be reported to SDRs. There are currently four SDRs that are provisionally registered with the CFTC.

The collection and public dissemination of swap data by SDRs helps regulators and the public. It provides regulators with information that can facilitate informed oversight and surveillance of the market and implementation of our statutory responsibilities. Dissemination, especially in real-time, also provides the public with information that can contribute to price discovery and market efficiency.

While we have accomplished a lot, much work remains. The task of collecting and analyzing data concerning this marketplace requires intensely collaborative and technical work by industry and the agency's staff. Going forward, it must continue to be one of our chief priorities.

There are three general areas of activity. We must have data reporting rules and standards that are specific and clear, and that are harmonized as much as possible across jurisdictions. The CFTC is leading the international effort in this area. It is an enormous task that will take time. We must also make sure the SDRs collect, maintain, and publicly disseminate data in the manner that supports effective market oversight and transparency. Finally, market participants must live up to their reporting obligations. Ultimately, they bear the responsibility to make sure that the data is accurate and reported promptly.

Our Agenda Going Forward

The progress I have outlined reflects the fact that the CFTC has finished almost all of the rules required by Congress in the Dodd-Frank Act to regulate the over-the-counter swaps market. This was a difficult task, and required tremendous effort and commitment. My predecessor, Gary Gensler, deserves substantial credit for leading the agency in implementing these reforms so quickly. All of the Commissioners contributed valuable insight and deserve our thanks. But no group deserves more credit than the hardworking professional staff of the agency. It was an extraordinary effort. I want to publicly acknowledge and thank them for their contributions.

The next phase requires no less effort. I want to highlight several areas going forward that are critical to realizing the benefits Congress had in mind when it adopted this new framework and to minimizing any unintended consequences.

- **Finishing and Fine-tuning Dodd-Frank Regulations**

First, as markets develop and we gain experience with the new Dodd-Frank regulations, I anticipate we will, from time to time, make some adjustments and changes. This is to be expected in the case of a reform effort as significant as this one. These are markets that grew to be global in nature without any regulation, and the effort to bring them out of the shadows is a substantial change. It is particularly difficult to anticipate with certainty how market participants will respond and how markets will evolve. At this juncture, I do not believe wholesale changes are needed, but some clarifications and improvements are likely to be considered.

In fine-tuning existing rules, and in finishing the remaining rules that Congress has required us to implement, we must make sure that commercial businesses like farmers, ranchers, manufacturers, and other companies can continue to use these markets effectively. Congress rightly recognized that these entities stand in a different position compared to financial firms. We must make sure the new rules do not cause inappropriate burdens or unintended consequences for them. We hope to act on a new proposed rule for margin for uncleared swaps in the near future. On position limits, we have asked for and received substantial public comment, including through roundtables and face-to-face meetings. This input has been very helpful enabling us to calibrate the rules to achieve the goals of reducing risk and improving the market without imposing unnecessary burdens or causing unintended consequences.

- **Cross-Border Regulation of the Swaps Market**

A second key area is working with our international counterparts to build a strong global regulatory framework. To succeed in accomplishing the goals set out in the G-20 commitments and embodied in the Dodd-Frank Act, global regulators must work together to harmonize their rules and supervision to the greatest extent possible. Fundamentally, this is because the markets that the CFTC is charged to regulate are truly global. What happens in New York, Chicago, or Kansas City is inextricably interconnected with events in London, Hong Kong and Tokyo. The lessons of the financial crisis remind us how easy it is for risks embedded in overseas derivatives transactions to flow back into the United States. And Congress directed us to address the fact that activities abroad can result in importation of risk into the United States.

This is a challenging task. Although the G-20 nations have agreed on basic principles for regulating over-the-counter derivatives, there can be many differences in the details. While many sectors of the financial industry are global in nature, applicable laws and rules typically are not. For example, no one would expect that the laws which govern the selling of securities, or the securing of bank loans, should be exactly the same in all the G-20 nations. While our goal should be harmonization, we must remember that regulation occurs through individual jurisdictions, each informed by its own legal traditions and regulatory philosophies.

Our challenge is to achieve as consistent a framework as possible while not lowering our standards simply to reach agreement, thus triggering a “race to the bottom.” We must also minimize opportunities for regulatory arbitrage, where business moves to locales where the rules are weaker or not yet in place.

The CFTC's adoption of regulations for systemically important CCPs is a useful model for success. Our rules were designed to meet the international standards for the risk management of systemically important CCPs, as evidenced by the Principles for Financial Market Infrastructures (PFMIs) published by the Bank of International Settlement's Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, to which the Commission was a key contributor.

Since the day I joined the CFTC, I have been focused on cross-border issues. In my first month in office I went to Europe twice to meet with my fellow regulators, and I have been engaged in ongoing dialogue with them.

- **Robust Compliance and Enforcement**

A third major area is having robust compliance and enforcement activities. It is not enough to have rules on the books. We must be sure that market participants comply with the rules and fulfill their obligations. That is why, for example, several weeks ago we fined a large swap dealer for failing to abide by our data reporting rules.

A strong compliance and enforcement function is vital to maintaining public confidence in our markets. This is critical to the participation of the many Americans who depend on the futures and swaps markets – whether they are farmers, oil producers or exporters. And even though most Americans do not participate directly in the futures and swaps markets, our enforcement efforts can help rebuild and maintain public confidence and trust in our financial markets.

We must aggressively pursue wrongdoers, big or small, and vigorously fulfill our responsibility to enforce the regulations governing these markets. Our pursuit of those who have manipulated benchmarks like LIBOR, a key global benchmark underlying a wide variety of financial products and transactions, is a prime example of this principle in practice. So is our successful litigation against Parnon Energy and Arcadia, two energy companies that systematically manipulated crude oil markets to realize illicit profits.

Dodd-Frank provided the Commission with a number of new statutory tools to ensure the integrity of our markets, and we have moved aggressively to incorporate these tools into our enforcement efforts. Our new anti-manipulation authority gives us enhanced ability to go after fraud-based manipulation of our markets. We have put that authority to good use in a host of cases and investigations, including actions against Hunter Wise and a number of smaller firms for perpetrating precious metals scams. Congress also gave us new authority to attack specific practices that unscrupulous market participants use to distort the markets, such as "spoofing," where a party enters a bid or offer with the intent to move the market price, but not to consummate a transaction. We used this new anti-spoofing provision to successfully prosecute Panther Energy for its spoofing practices in our energy markets.

Going forward, protecting market integrity will continue to be one of our key priorities. Market participants should understand that we will use all the tools at our disposal to do so.

- **<u>Information Technology and Data Management</u>**

It is also vital that the CFTC have up to date information technology systems. Handling massive amounts of swaps data and effective market oversight both depend on the agency having up-to-date technology resources, and the staff – including analysts and economists, as well as IT and data management professionals – to make use of them. The financial markets today are driven by sophisticated use of technology, and the CFTC cannot effectively oversee these markets unless it can keep up.

Cyber-security is a related area where we must remain vigilant. As required by Congress, we have implemented new requirements related to exchanges' cyber-security and system safeguard programs. The CFTC conducts periodic examinations that include review of cyber-security programs put in place by key market participants, and there is much more we would like to do in this area. Going forward, the Commission's examination expertise will need to be expanded to keep up with emerging risks in information security, especially in the area of cyber-security.

Resources and Budget

All of these tasks represent the significant increases in responsibility that came with Dodd Frank. They require resources. But the CFTC does not have the resources to fulfill these tasks as well as all the responsibilities it had – and still has – prior to the passage of Dodd Frank. The CFTC is lucky to have a dedicated and resourceful professional staff. Although I have been at the agency a relatively short time, I am already impressed by how much this small group is able to accomplish. Still, as good as they are, the reality of our current budget is evident.

I recognize that there are many important priorities that Congress must consider in the budgeting process. I appreciate the importance of being as efficient as possible. I have also encouraged our staff to be creative in thinking about how we can best use our limited resources to accomplish our responsibilities. We will keep the Teddy Roosevelt adage in mind, that we will do what we can, with what we have, where we are.

But I hope to work with members of Congress to address our budget constraints. Our current financial resources limit our ability to fulfill our responsibilities in a way that most Americans would expect. The simple fact is that Congress's mandate to oversee the swaps market in addition to the futures and options markets requires significant resources beyond those the agency has previously been allocated. Without additional resources, our markets cannot be as well supervised; participants cannot be as well protected; market transparency and efficiency cannot be as fully achieved.

Specifically, in the absence of additional resources, the CFTC will be limited in its ability to:

- Perform adequate examinations of market intermediaries, including systemically important DCOs and the approximately 100 swap dealers that have registered with the Commission under the new regulatory framework required by Dodd-Frank.

- Use swaps data to address risk in a marketplace that that has become largely automated, and to develop a meaningful regulatory program that is required to promote price transparency and market integrity.

- Conduct effective daily surveillance to identify the buildup of risks in the financial system, including for example, review of CFTC registrant activity reports submitted by Commodity Pool Operators and banking entities, as well as to monitor compliance with rules regarding prohibitions and restrictions on proprietary trading.

- Investigate and prosecute major cases involving threats to market integrity and customer harm and strengthen enforcement activities targeted at disruptive trading practices and other misconduct of registered entities such as precious metals schemes and other forms of market manipulation.

Conclusion

A few core principles must motivate our work in implementing Dodd-Frank. The first is that we must never forget the cost to American families of the financial crisis, and we must do all we can to address the causes of that crisis in a responsible way. The second is that the United States has the best financial markets in the world. They are the strongest, most dynamic, most innovative, most competitive and transparent. They have been a significant engine of our economic growth and prosperity. Our work should strengthen our markets and enhance those qualities. We must be careful not to create unnecessary burdens on the dynamic and innovative capacity of our markets. I believe the CFTC's work can accomplish these objectives. We have made important progress but there is still much to do. I look forward to working with the members of this Committee and my fellow regulators on these challenges.

Thank you again for inviting me today. I look forward to your questions.