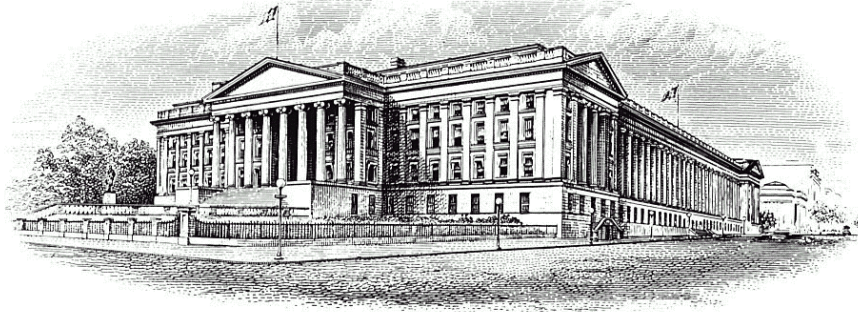




DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

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Testimony of Randy K. Quarles, Under Secretary for Domestic Finance U.S. Department of the Treasury

Before the Senate Committee on Banking, Housing, and Urban Affairs

Thank you Chairman Shelby, Ranking Member Sarbanes, and other members of the Committee. I appreciate the opportunity to address certain issues that have arisen in the context of congressional reauthorization of the Commodity Futures Trading Commission (CFTC). As you know, Treasury is a member of the President's Working Group on Financial Markets and the Secretary serves as the PWG's chairman. The other members of the PWG are the Chairmen of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

In recent weeks, the PWG members and senior staff have met to discuss the effect of last year's 7th Circuit Court of Appeals decision in **CFTC v. Zelener** on the CFTC's antifraud authority, in particular the CFTC's ability to address retail foreign exchange fraud by otherwise unregulated entities. The proposal we have produced reflects a consensus of the President's Working Group that would make narrow changes to the CFTC's antifraud authority to provide the CFTC with enforcement tools to combat fraud against retail customers involving certain foreign exchange contracts, while preserving the complex and delicate compromises reached in the Commodity Futures Modernization Act of 2000 (CFMA). In this regard, the President's Working Group opposes extension of such provisions beyond retail foreign exchange contracts to other commodities.

The Importance of the Commodity Futures Modernization Act of 2000

The CFMA provided important legal certainty to risk management efforts. Businesses, financial institutions, and investors throughout the economy rely on derivatives products to protect them from market volatility and unexpected events. The ability to manage risks makes the economy more resilient to financial and economic events and imbalances, and its importance cannot be underestimated. Consequently, the President's Working Group believes that major changes to the significant modernizations made by the CFMA are not warranted.

The CFMA modified the Commodity Exchange Act (CEA) so that provisions of the Act (including anti-fraud provisions) apply to foreign exchange futures and certain options with retail customers if the counterparty is not an otherwise-regulated entity such as a financial institution, broker-dealer, Futures Commission Merchant (FCM), or insurance company. Those changes were intended to provide the CFTC with tools to pursue fraud against retail customers by bucket shops offering certain foreign exchange contracts. In the 2004 **Zelener** case, the CFTC's jurisdiction over a retail foreign exchange contract was challenged, and the 7th Circuit found that the CFTC lacked jurisdiction over the specific contract in question. The President's Working Group is supportive of narrow and tailored changes to the CEA that would address the Zelener issue.

Pursuing Retail Foreign Exchange Fraud

The changes we are proposing would be limited to cover only certain retail foreign exchange contracts that have been the subject of abuse. Any such changes must be very carefully formulated to avoid creating barriers or undue burdens for legitimate businesses, undermining legal certainty, and creating unintended consequences. As a consequence, the President's Working Group opposes the extension of such provisions for retail foreign exchange contracts to other commodities, absent a clearly demonstrated need and thorough public policy debate.

President's Working Group Consensus on Pursuing Retail Foreign Exchange Fraud

At the direction of the President's Working Group, senior staff of PWG member agencies have been meeting frequently to discuss and draft a legislative proposal to address fraud perpetrated against retail customers using futures or futures-like foreign exchange contracts. The staff group has drafted language that would accomplish that goal in two ways: 1) by applying the CEA or its anti-fraud provisions to certain retail foreign currency futures and certain options, and their sales chains, when an FCM is involved; and 2) by applying the anti-fraud provisions to certain retail foreign exchange contracts that are not securities, contracts that result in actual delivery within two days, or certain contracts in connection with a line of business, as well as to their sales chains.

The PWG proposal makes futures transactions and certain options in foreign currency between a retail participant and a counterparty that is not an otherwise-regulated entity – such as a financial institution, broker-dealer, or insurance company – subject to the CEA. It also would provide the CFTC with antifraud jurisdiction over such retail foreign exchange contracts, and the persons who engage in activity in connection with those contracts, if the counterparty is an FCM. Any person who participated in the solicitation or recommendation of any such contract within the FCM sales chain would have to register with the CFTC and be a member of a registered futures association, in this case the National Futures Association (NFA), the futures industry's sole self-regulatory organization. The PWG proposal would preserve the exclusion for otherwise-regulated entities crafted by the CFMA.

Retail Foreign Exchange Futures-Like Contracts

The PWG proposal would make certain foreign currency contracts between a retail participant and a counterparty that is not an otherwise-regulated entity subject to CFTC antifraud jurisdiction if the contracts were leveraged, margined, or financed, except that they would not

apply to securities, contracts that result in actual delivery within two days, or certain contracts in connection with a line of business. It also would make such retail foreign exchange contracts and the persons who engage in activity in connection with those contracts subject to the antifraud provisions of the CEA. Additionally, any person who participated in the solicitation or recommendation of any such contract would have to register with the CFTC and be a member of the NFA. Again, this proposal would preserve the previous carefully crafted CFMA exclusion for otherwise-regulated entities.

Portfolio-Style Margining Systems

The CFMA granted to the Board of Governors of the Federal Reserve System (Board) the authority to establish margin requirements for security futures products. The Board delegated that authority to the SEC and CFTC jointly. The SEC and CFTC continue to work towards permitting portfolio-style margining models. The Treasury Department generally supports the concept of portfolio-style margining systems, which increase the efficiency of capital allocation and encourage risk management activities. We note that some progress has been made very recently and we remain hopeful that the SEC and CFTC can work together to facilitate the implementation of such margining systems soon.

Securities Futures Products and Narrow-Based Indexes

The CFMA created a distinction between broad-based security indexes, which have been regulated solely by the CFTC, and narrow-based security indexes, which are regulated by the SEC and CFTC jointly. The definition of “narrow-based security index” seems to have been formulated using criteria appropriate for equity securities, as opposed to debt securities. The Treasury Department generally supports reviewing the appropriateness of certain criteria in the definition of “narrow-based security index” in the context of debt and foreign security index futures given that the nature of the underlying securities differs from domestic equities.