

**Testimony of De'Ana H. Dow
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"The CFTC at 50: Examining the Past and Future of Commodity Markets"

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Good morning, Chairman Thompson, Ranking Member Craig and esteemed members of the Committee. Thank you for the opportunity to testify today. My name is De'Ana Dow, and I am a Partner and General Counsel at Capitol Counsel LLC, where I specialize in advising clients on a wide range of regulatory and legislative matters related to futures and derivatives markets. I began my legal career at the Commodity Futures Trading Commission (CFTC) in 1980, in the Division of Trading and Markets. I later served as counsel to Commissioner Barbara Holum, Chairman Bill Rainer and Chairman Jim Newsome. After 22 years at the CFTC, I continued my regulatory work at FINRA, then called NASDR, providing regulatory services to security futures and carbon markets, and then served in senior legal roles at the New York Mercantile Exchange and CME Group, before moving to a multi-client platform.

Background

I have been asked to speak today about the Commodity Futures Modernization Act (CFMA), a law that brought the most substantial revisions to the Commodity Exchange Act (CEA or Act) since the creation of the CFTC and fundamentally restructured the regulation of exchange-traded derivatives. The CFMA, among other things, addressed legal certainty and ensured the enforceability of over-the-counter swaps, adopted core principles-based regulation transforming the CFTC's role in overseeing futures markets, lifted the ban on single-stock futures and narrow-based stock indices, established direct regulation of derivatives clearing houses, and added new products-based exclusions and exemptions.

For purposes of this hearing, I will focus on the CFMA amendments to the CEA that introduced principles-based regulation and changed the trajectory of the futures and derivatives industry. Specifically, I will focus on the core principles of regulatory framework, addressing why it was adopted, how it works, the significant impact of less prescriptive regulation on promoting innovation and competition, and the growth of more deep and liquid markets for hedging and price-basing.

First, to give credit where credit is due, then-Chairman Bill Rainer had a vision for a strong regulatory regime that allowed exchange-traded markets to compete, innovate, and grow. He appointed Paul Architzel to work with an internal CFTC task force to draft a new regulatory framework that ultimately became the CFMA. Signed into law in December 2000, the CFMA revamped the regulation of designated

contract markets by substituting an approach based on flexible core principles for the prescriptive regulations under the prior law. The regulations adopted under the CFMA set forth acceptable practices for compliance with the core principles, a certification process for new rules, rule amendments, and new product listings, and shortened timeframes for the rule review process. These were all components of a new approach to regulating exchange-traded derivatives designed to foster the growth of deep and liquid markets that are critical for commercial hedging.

This substantial rewrite of the CEA addressing exchange-traded derivatives, in part, responded to significant challenges associated with the ability of regulated markets to compete with the growing over-the-counter (OTC) swaps markets. Interest rates, foreign currencies, other financial futures contracts, and energy and agricultural swaps contracts were trading OTC without regulation, while on-exchange trading of the same instruments was subject to heavy-handed regulation that impeded the ability of regulated markets to compete, innovate, and grow. As a result of the CFMA, U.S. futures markets experienced exponential growth, successfully competing with derivatives markets globally, on- and off-exchange. A report authored by CFTC economists in 2008 stated that futures and options open interest quintupled between 2000 and 2008.¹ Similarly, a Bank for International Settlements report released in May 2012, found that from 2000 until the end of 2008, the volume of derivatives contracts traded on-exchange globally grew by 475%.²

The benefits of the growth of exchange-traded futures are clear. More regulated and transparent trading in these economically important markets ensured market integrity and customer protection. In addition, deep and liquid markets ensure an accurate price discovery function for commercial hedgers. Moreover, the CFMA fostered innovation and expanded the use of electronic trading platforms in a space dominated by trading floors, hand signals, handwritten order tickets, and trading cards with timestamps. A key goal of the CFMA was to ensure proper regulation and oversight of financial markets without stifling innovation or market growth. By right-sizing regulation of these markets, the CFMA ensured the U.S. financial markets' competitiveness in global markets and innovation.

The CFMA – A New Regulatory Framework

The CFMA included criteria for designation as a contract market and requirements to maintain that designation. In order to list futures contracts for trading, a market must apply to the Commission to become a Designated Contract Market (DCM). A market applying for designation as a contract market must meet specified criteria, including having the capacity to prevent market manipulation, provide public access to its rules, regulations and contract specifications, and establish and enforce rules that: 1) promote fair and equitable trading; 2) govern market operations; 3) ensure financial integrity of transactions on the board of trade; 4) implement disciplinary

¹ "Fundamentals, Trader Activity and Derivative Pricing" by Bahattin Buyuksahin, Michael S. Haigh, Jeffrey H. Harris, James A. Overdahl and Michael Robe (December 4, 2008).

² Bank of International Settlements, "Statistical release: OTC derivatives statistics at end-December 2011" (May 2012).

procedures; and 5) enable the market to obtain any information necessary to perform these duties.

To maintain designation, a contract market must adhere to 18 core principles, such as: 1) enforcing compliance with its rules; 2) listing contracts not readily susceptible to manipulation; 3) monitoring trading to prevent abuses; 4) providing for the financial integrity of transactions and protecting customer funds; 5) protecting participants from abusive practices; 6) establishing proper fitness standards for directors and those with trading privileges, among other requirements.

Implementing regulations carefully incorporated the flexible core-principles approach contemplated by Congress. Express language included in the CFMA provides, as follows:

“Reasonable Discretion of Contract Markets. – Unless otherwise determined by the Commission by rule or regulation, a board of trade ... shall have reasonable discretion in establishing the manner in which the board of trade complies with the core principles described in this subsection.” (Section 5(d)(1)(B))

In effect, although the CFTC is authorized to issue interpretations of the core principles, the Act expressly provides that the CFTC’s interpretations are not the exclusive means of complying with the core principles. This express language effectively removed the Commission’s longstanding prescriptive approach to rulemaking and opened the door for exchanges to adopt rules, policies, and procedures appropriate for the markets.

In implementing the statutory provisions, the Commission adopted Part 38 of its regulations, which set forth 18 core principles applicable to designated contract markets. It also adopted Appendix B to Part 38 – “Guidance on, and Acceptable Practices in, Compliance with Core Principles”. These were not prescriptive rules, but guidance on how a DCM could comply with the core principles. The Commission built in timeframes for the designation of new exchanges and the review of new rules and rule amendments, and included a self-certification process for rules that did not need prior approval. These timeframes and permissionless rule certifications dramatically reduced the time to market for new exchanges and new products, and the timeframe for implementation of new and amended rules.

It is important to note here that these compressed timelines and certification processes in no way diminished the effectiveness of the regulatory regime over these markets. In the CFTC’s 50-year history, no futures exchange or clearing house has failed due to market forces in a way that left customers and intermediaries with losses. Moreover, the markets have performed well in the midst of market events and crises triggered by geopolitical events, terrorist attacks, a pandemic, and other severe shocks to the financial system.

Also noteworthy, the principles-based regulation resulted in greater market liquidity. Deep and liquid markets are essential for commercial end-users seeking to manage the risk of changes in commodity prices and determine the best price for a

commodity. The interplay of buyers and sellers in an open and competitive market quickly establishes what a commodity is worth at any given moment. Hedging and price basing are the overarching purposes of futures markets, and the more liquid they are, the more effective.

Here is a high-level overview of how the self-certification process works for new product listings. Under CFTC regulation 40.2, listing new products for trading by certification permits listing without prior approval if it complies with certain conditions, including a certification that the product listed complies with the CEA and Commission regulations. The submission must include an explanation and analysis of the product and its compliance with core principles and the Commission's regulations thereunder. The submission must be received by the Commission by the open of business on the business day preceding the product's listing. Relative to this process, the Commission may request additional information from the registered entity that demonstrates that the contract meets the requirements of the CEA, or the Commission's regulations. Part (40.2(b)). In addition, the Commission may stay the listing of a contract during the pendency of Commission proceedings for filing a false certification or during the pendency of the proceeding to alter or amend the contract terms or conditions under Section 8a(7) of the Act. (Part 40.2 (c)).

With respect to rule certifications, regulation 40.6 requires, among other things, that the submission include a certification that the rule complies with the Act and Commission regulations, and an explanation and analysis of the operation, purpose and effect of the proposed rule or amendment and its compliance with applicable provisions of the Act and regulations. The Commission must receive the submission no later than the open of business on the business day 10 business days prior to the registered entity's implementation of the rule amendment. The Commission has a 10-day window to review the new rule or rule amendment before it is deemed certified and can be made effective unless the Commission notifies the registered entity during the 10-day review period that it intends to issue a stay of the certification. The grounds for a Commission stay of a rule certification are: 1) the rule or rule amendment presents novel or complex issues that require additional time to analyze; and 2) the rule or rule amendment was accompanied by an inadequate explanation and is potentially inconsistent with the Act or Commission regulations. The Commission would then have an additional 90 days from the date of the notification to conduct the review. (Part 40.6(c)).

Registered entities can continue to seek prior review and approval of new products and rules by voluntarily submitting them to the Commission. The timeframe for review and approval of new products, rules, and rule amendments is 45 days. The Commission is required to approve the new product unless its terms and conditions violate the Act or Commission regulations. Likewise, the Commission must approve the new rule or rule amendment unless it is inconsistent with the Act.

The flexible core principles regime, a cornerstone of the CFMA, coupled with the reasonable timelines for Commission action on pending products and rules have worked extremely well for the industry and the Commission. This explanation of the self-certification process and review process is intended to give you a picture of a robust regulatory program that effectively oversees the futures markets, protects

customers, ensures market integrity, and enforces antifraud and anti-manipulation requirements. It should be noted that there is frequent open and constructive dialogue between the regulators and registered entities seeking to list new products and implement new or amended rules. This regulatory framework is tried and proven and should be preserved.

In addition to streamlining the regulatory process and ushering in a flexible, core principles-based approach to regulation, the CFMA revamped the regulations with a focus on the commodity being traded. For the first time, the Commission would differentiate between classes of commodities, abandoning the historical approach of regulating all commodities the same. Under the CFMA, three different classes of commodities emerged: agricultural commodities, energy and precious metals commodities, and financial commodities. The core principles for each class flowed from addressing the regulatory requirements needed based on the type of commodity traded. In addition, physical delivery contracts would be treated differently from cash-settled contracts. This approach has worked well to ensure appropriate commodities-focused regulation.

The CFMA also established a regulatory framework for clearing organizations, giving the CFTC clear jurisdiction over Derivatives Clearing Organizations (DCOs), which previously had been regulated only through the clearing house's relationship with the futures exchange to which it was attached. The law required futures contracts and options on futures contracts to be cleared by a DCO and required the DCO to be registered with the Commission. To become and remain a DCO, an entity must demonstrate compliance with specified core principles designed to ensure the financial integrity of the DCO. There currently are 19 registered DCOs.

Conclusion

For 50 years, the CFTC has effectively regulated futures markets, keeping pace with change and adapting regulations to fit the ever-evolving markets. In those 50 years, the CFTC and its regulated markets have remained resilient and strong even in the face of events that threatened the markets. While the CFMA helped foster innovation and growth in the exchange-traded and OTC markets, it is essential to continue adapting regulations to ensure both market efficiency and financial stability. With the interconnectedness of markets, both domestic and global, it is also important to guard against systemic risk. The CFTC has the unique expertise to oversee futures markets trading and clearing and to enforce antifraud and anti-manipulation in those markets.