

United States House of Representatives
Committee on Agriculture
“The Future of Digital Assets: Providing Clarity for Digital Asset Spot Markets”

The Honorable Walter L. Lukken
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Chairman Thompson, Ranking Member Scott, and Members of the Committee, thank you for the opportunity to highlight some of the benefits of the Commodity Futures Trading Commission’s (CFTC’s) principles-based regulatory framework as you deliberate providing the Commission with expanded regulatory jurisdiction over digital asset spot markets.

I am the President and Chief Executive Officer of the Futures Industry Association (FIA). FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets. FIA’s membership includes clearing firms, also known as futures commission merchants (FCMs), exchanges, clearinghouses, trading companies, and commodities specialists from more than 48 countries as well as technology vendors, law firms and other professionals serving the industry.

Our industry’s primary market regulator in the United States is the CFTC and many of our industry’s market participants are also registered with the National Futures Association (NFA), the independent self-regulatory organization (SRO) for the US derivatives industry. It’s worth highlighting that our markets are global in nature and that many of our members are registrants with not only the CFTC, but also the Securities Exchange Commission (SEC) in the US as well as other regulators in jurisdictions around the world.

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 Acting Chairman from June 2007 to January 2009 during the height of the financial crisis. Prior to the CFTC, I also served as a member of the professional staff of the Senate Agriculture Committee where I was involved with the passage of the Commodity Futures Modernization Act of 2000 that created the principles-based regulatory system we have in the futures markets today.

FIA and its members look forward to reviewing the Committee’s draft digital asset market structure legislation and providing feedback. Today, I am honored to testify about my significant experience with the Commodity Exchange Act (CEA) and the exchange traded derivatives markets both inside and outside the government.

I believe the CEA is uniquely positioned to keep pace with our ever-changing markets, including digital assets. As this Committee deliberates about the oversight of the spot digital asset market, it would be well-served to study the three pillars of the CFTC’s regime: its flexible principles regulatory framework, its battle-tested customer protection regime, and its strong enforcement capabilities.

I hope my testimony will be helpful to Members of this Committee as you consider whether the existing framework for the regulation of the exchange-traded and cleared derivatives markets in the US should be extended to spot digital asset markets.

A Flexible Principles-Based Regulatory Framework

Next year, we celebrate the 50th anniversary of the Commodity Futures Trading Commission Act of 1974. This bill, and subsequent reforms over the following five decades, have given the CFTC a powerful regulatory framework that allows the agency to police fraud, abuse, and manipulation in the markets while encouraging responsible innovation and fair competition among participants. This Committee should be commended for its foresight in developing this flexible regulatory structure that has allowed these markets to grow and develop while protecting market participants and the public from harm.

The CFTC Act of 1974 modernized the regulatory structure for the US futures markets, creating the independent agency of the Commodity Futures Trading Commission and giving it exclusive jurisdiction over futures contracts traded on commodities. The Act also broadened the definition of “commodity” beyond agricultural products to include financials, energies, and “all other goods...articles...services, rights and interests...”

This expansion was done to capture financial products that were beginning to be listed on boards of trade, but this catch-all language also served to “future-proof” the regulation of new products that may not have been contemplated when the Act was first drafted.

This flexible definition, combined with Congress’s grant of exclusive jurisdiction, became a powerful “one-two” punch for the agency, allowing the CFTC to provide clear rules of the road for futures markets and enabling new products to develop without duplicative regulations that could harm innovation. Indeed, over the last five decades, we have seen innovative futures contracts launched on interest rates, equity indices, carbon offsets, volatility, and even digital assets.

The CFTC Act of 1974 also authorized the creation of an independent self-regulatory organization (SRO), known as a Registered Futures Association, that would help the CFTC oversee the registration, auditing, and policing of market participants who interact with customers and their funds. In 1982, the National Futures Association was launched. Over its 40 years of existence, it has greatly contributed to preserving the integrity of US derivatives markets, protecting retail investors and ensuring registrants meet their regulatory responsibilities.

In 2000, Congress passed another major reform of the futures markets, again with the aim of providing the agency with powerful tools aimed at keeping pace with innovation and growth. The bipartisan Commodity Futures Modernization Act of 2000 provided the CFTC with a new principles-based regulatory regime for exchanges and clearinghouses, among other reforms.

In its two decades of existence, the CFTC’s core principles regime has been a resounding success due to its flexible but clear approach. The Act provides the CFTC with the ability to issue guidance and rules on how a regulated entity complies with the various core principles. However, there is also built-in flexibility for entities to take a different approach if they can prove the core principles are still being met.

These core principles include such directives as requiring exchanges to only list contracts that are not readily subject to manipulation, and ensuring exchanges have the capacity and responsibility to prevent manipulation, price distortion, and disruptions through market surveillance, compliance, and enforcement practices.

Such flexible regulations have helped the CFTC extend its regulatory regime cross-border over the preceding three decades. Many benchmark products listed on regulated futures markets are global in nature and serve as global reference prices for companies trying to manage their risk exposures in our markets. FIA estimates that a significant amount of CFTC-registered exchange trading volume comes from cross border transactions.¹ To meet this global demand from the marketplace, the CFTC has used its flexible regulatory regime to develop an effective cross-border regulatory framework built on foreign authority cooperation and regulatory comparability and recognition. This global framework aligns well with the cross-border nature of the digital commodity markets and could represent an effective approach for ensuring these global markets abide by comparable standards of regulation.

For new and innovative entrants, like digital asset trading platforms, this flexible and global approach to regulation is an extremely attractive framework that allows for new models and approaches to develop organically without compromising oversight.

Customer Protections Under the CEA

While the futures markets are largely institutional, the CFTC and NFA have a strong track record of protecting customer funds and stamping out fraud and abuse affecting retail customers in our markets.

The CEA contains strong disclosure and money segregation requirements aimed at protecting customers utilizing our markets. Since the passage of the CEA in 1936, FCMs have been required to segregate customer funds on behalf of customers, and their interactions with customers have been heavily regulated to protect customers and market stability. These protections include risk disclosures, capital resources, credit and collateral management, anti-money laundering requirements, guaranteeing customer trades, and "know your customer" obligations.

Another key customer protection afforded by the current CFTC regulatory framework is the compartmentalization of risk inherent in the intermediated, and leveraged, nature of the futures markets. As agents for their customers, intermediaries serve to protect the interests and funds of their clients. Advancements in technology have enabled various roles within our markets, including exchanges, intermediaries, and market makers, to be combined into one platform. While there may be some efficiencies in this model, there are also inherent conflicts of interest and risks that may arise, and we saw this with the demise of FTX. While FIA is continuing to review the Committee's draft bill, we appreciate that it includes language that seeks to address these conflicts of interest that could arise on certain digital asset trading platforms.

In addition to these preventive measures, the CFTC and NFA have taken strong enforcement actions over the years against boiler rooms and fraudulent players that have targeted retail customers. One prime example is in retail foreign currency trading, known as forex. In 1974, Congress excluded the interbank foreign currency markets from the CFTC's jurisdiction, given the fact these institutional markets were already overseen by prudential regulators. This exclusion, known as the Treasury Amendment, carved out transactions involving foreign currencies that were not "for future delivery" and "conducted on a board of trade."

¹ <https://www.fia.org/fia/articles/statement-united-states-house-representatives-committee-agriculture-subcommittee>

This language created a gap in the oversight regime for retail participants transacting in off-exchange foreign currencies. In many cases, these contracts were leveraged, margined, and financed, much like futures contracts. I was Acting Chair of the CFTC in 2007 and 2008, and we saw an enormous increase in retail forex fraud. Unfortunately, this legal uncertainty, and adverse court decisions, prevented the CFTC from taking decisive action against this abuse.

To close this loophole, Congress approved amendments to the CEA in 2008 that granted additional protections to retail participants in the forex market. These changes, known as the “Zelener Fix,” required all margined, financed and leveraged retail transactions to occur on a CFTC regulated exchange and required retail customers to use a registered broker to access these markets. In addition, the CFTC promulgated regulations introducing a new category of registrant called a retail foreign exchange dealer (RFED) to complement the existing categories for futures brokers, in addition to requiring RFEDs to register with NFA.

Once Congress provided legal clarity for retail forex, the CFTC and NFA were able to step in and set limits on leverage, require brokers to register and be well-capitalized, and aggressively enforce rules against fraud. Ultimately, this new authority in the hands of the CFTC and NFA eliminated significant fraud and abuse in these retail markets, driving many of the bad actors out of business.

While the CFTC has recently noted a rise in retail participation in the futures markets, the customer protection regime in place appears to be working as we are not seeing an increase in customer complaints and retail fraud cases. NFA highlighted this in a May 2022 CFTC comment letter² that “customer complaints and single-event customer arbitrations filed at NFA, as well as CFTC reparation cases, remain near all-time lows.” This demonstrates that the Congressionally established regulatory framework, and the efforts of the CFTC and NFA, have contributed greatly to ensuring that robust customer protections are in place and being enforced.

If Congress decides to provide similar regulatory oversight of the spot digital asset markets to the CFTC, and NFA, I am confident they would be well prepared to provide the same level of protections that customers receive on US exchange-traded and cleared derivatives markets.

Strong Enforcement

To complement the CFTC’s principles-based regime, the agency has exercised its expansive enforcement authorities to punish wrongdoing and to serve as a powerful deterrent for other bad actors.

While the CFTC does not have statutory authority to regulate spot digital asset markets, it does have certain enforcement powers over all spot markets in commodities, and it has used those powers to bring more than 80 enforcement actions involving wrongdoing in digital asset commodities. CFTC enforcement actions related to digital assets have primarily targeted exchanges that illegally offer derivatives and leveraged, margined, or financed virtual currency transactions. The agency has also targeted businesses that engage in fraud and manipulative behavior, as well as foreign platforms that do not establish adequate safeguards and controls to prevent US persons from accessing their platforms.

It should also be noted that, beyond digital assets, the CFTC has a proven track record of preserving market integrity through its enforcement actions, including its expertise on policing market

² <https://www.nfa.futures.org/news/newsComment.asp?ArticleID=5476>

manipulation. The agency has brought forward successful enforcement manipulation cases against energy and agricultural companies as well as the precedent-setting case on the manipulation of the LIBOR benchmark. The agency has also successfully used its authorities to root out disruptive trading practices, including illegal spoofing. Given the potential of disruptive trading and manipulation in the spot digital asset marketplace, the CFTC's enforcement authorities and proven track record make the Commission well-positioned to protect customers in this the space, should Congress decide to provide that authority.

Conclusion

Thank you for the opportunity to testify about the history of the CFTC and the benefits of the Commission's principles-based regulatory framework and how its flexible approach to regulation protects customers, promotes innovation, and preserves market integrity.

I hope my testimony will be helpful to Members of this Committee as you consider whether the existing framework for the regulation of the exchange-traded and cleared derivatives markets in the US should be extended to spot digital asset markets.