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Speech

The U.S. Regulatory Landscape: The View from Washington

Speech by Commissioner Jill E. Sommers, Commodity Futures Trading Commission, FIA/FOA International Derivatives Expo, London

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Thank you to Steve and John for hosting this great event, and I wish everyone a good morning. As you all know, this is a period of great change in the area of financial regulation, and it seems that proposals are emanating on an almost daily basis from London, Brussels and Washington. Last week, Commissioner McCreevy visited the CFTC, and he emphasized that Europe and the United States should coordinate on these ongoing regulatory initiatives. It is in that spirit that I am here to give you an update on what's been going on in my corner of the world in Washington.

First, I am very happy to report that Gary Gensler, the new chairman of the CFTC, is now on the job having been confirmed by the Senate on May 19th with broad bipartisan support. I think I can safely speak on behalf of my fellow Commissioners when I say that there has never been a more critical need for strong leadership at the agency. Although the regulated futures exchanges and futures firms have performed well throughout the financial crisis, there is widespread belief that measures should be taken to prevent a recurrence of the run up in commodity prices that occurred last year, and broad consensus that more transparency must be brought to the over-the-counter (OTC) markets.

The CFTC's last two chairmen, Walt Lukken and Michael Dunn, who served in "acting" capacities, both worked diligently during their tenures to get a better handle on the how hedge exemptions for index traders and swaps dealers may be affecting the markets and each spearheaded important initiatives to strengthen the regulatory structure in a number of ways. The political reality, however, is that big changes are difficult to implement when an acting chairman is at the helm and big changes, I believe, are on the horizon. So, I am very glad that we now have a confirmed chairman of Gary Gensler's caliber to lead the CFTC as the details of regulatory reform are worked out.

I am sure that by now many of you are familiar with the broad framework for regulatory reform announced by the U.S. Secretary of the Treasury, Timothy Geithner, dealing specifically with recommendations for establishing a comprehensive regulatory framework for OTC derivatives. In Congressional testimony last week, Chairman Gensler voiced his full support for Secretary Geithner's proposals and provided more detail regarding his vision of what the regulatory regime should include.

Specifically, Chairman Gensler committed to working with the Congress and the CFTC to bring more transparency to the markets by comprehensively regulating both derivative dealers and the markets in which derivative dealers trade. This regulatory regime would subject OTC derivatives dealers to conservative capital requirements, initial margin requirements, business conduct rules and recordkeeping and reporting requirements.

In addition, derivative markets would be regulated, based on the following four principles:

1. Require all standardized OTC products to be cleared through regulated clearinghouses;
2. Move standardized portions of these markets onto regulated exchanges and regulated transparent electronic trading systems;
3. Develop a system for reporting and disseminating OTC prices and other OTC trade information; and
4. Require all OTC transactions, both standardized and non-standardized, to be reported to a regulated trade repository, make aggregate data on open positions available to the public, and data on individual trades and positions available to the CFTC and other regulators on a confidential basis.

Chairman Gensler also called for clear CFTC authority to police fraud, manipulation and excessive speculation in the OTC space and for the need to establish position limits. In order to prevent traders from avoiding position limits by moving to a related exchange or market, he recommended that the agency be given the power to set limits on OTC positions and that limits be aggregated across all markets and trading platforms, including foreign exchanges that have received no-action relief from the CFTC to offer look-alike contracts to U.S. customers. He urged, moreover, that Congress give the CFTC clear authority to promulgate rules governing foreign boards of trade doing business in the U.S.

By anyone's measure this is an ambitious agenda. And our policy initiatives are complicated by the fact that much of it will require amendments to the Commodity Exchange Act (CEA) and other laws. In addition, we will need to resolve thorny questions such as:

- how to define standardized derivatives;
- which regulator or regulators should oversee trade repositories;
- how in practice can position limits across all markets be aggregated and enforced; and

- should clearing facilities for OTC derivatives be able to choose their regulator, similar to the model developed for credit default swaps, and if so, how do we ensure that uniform standards are applied across the board, to name just a few.

I don't like to predict how any legislative process might unfold, but given the complexity of the issues it seems likely that ironing out the details will take time. I look forward to working with Chairman Gensler, my fellow Commissioners, and other decision makers as we move forward.

In the meantime, despite the absence of a confirmed chairman, we have not been standing still at the CFTC. To the contrary, our staff has worked many long hours over the past year to help the Commission resolve some long standing issues and to propose new initiatives to strengthen the regulatory structure. I'd like to mention just a few of these projects that may be of interest to you.

In January of this year the Commission amended its no-action policy for foreign boards of trade that permit direct access by U.S. customers to close what's been referred to as the "London loophole." Under the Commission's new policy, foreign exchanges that list contracts linked to contracts listed on U.S. exchanges must adopt speculative position limits or accountability rules comparable to those of the linked U.S. exchange; identify traders with positions above the limit and whether they were granted a hedge exemption and if not, whether disciplinary action was taken; publish daily trading information on volume, open interest, settlement prices and opening and closing ranges; and provide the CFTC with a daily report of large trader positions in each linked contract for all contract months. The only foreign exchange currently affected by the new policy is ICE Futures Europe, which lists a WTI crude oil contract linked to the contract listed on the New York Mercantile Exchange. As I mentioned earlier, Chairman Gensler has stated that he is in favor of statutory authority that would allow the Commission to formalize this policy through rulemaking, and I expect that this is something that will be considered in any legislation that is formulated by Congress.

In addition, the Commission finalized rules this year to close what's been called the "Enron loophole," a provision in the law that allowed unregulated exempt commercial markets (ECMs) to offer contracts based on certain commodities, such as energy, to sophisticated market participants. Pursuant to legislation passed last year, the Commission is now authorized to regulate contracts listed on ECMs in a manner similar to those offered on registered exchanges when the contract serves a significant price discovery function (significant price discovery contracts or SPDCs). Under the legislation, the Commission must review all ECM contracts by October 19, 2009 (180 days after the effective date of the final rules), to evaluate which contracts serve a significant price discovery function and must solicit public comment on its determinations. The Division of Market Oversight has identified 89 contracts to review in this initial SPDC determination period. The Commission will issue orders explaining the basis for its decisions in this area when final determinations are made.

Another big project the Commission finalized this year is the issuance of acceptable practices for demonstrating compliance with Core Principle 15 of the CEA, which requires exchanges to minimize conflicts of interest in their decision making process. The acceptable practices require exchanges to ensure that at least 35 percent of their boards of directors qualify as public directors, to establish regulatory oversight committees comprised exclusively of public directors to oversee their self-regulatory programs, and to appoint at least one public person to all disciplinary panels. A director's qualification as "public" turns on whether he or she has a material relationship with the exchange, which is one that reasonably could affect the independent judgment or decision making of the director. The guidance sets forth certain bright-line tests that automatically establish a material relationship, but also requires exchanges to go beyond the bright-line tests to determine on the record whether a material relationship exists.

An ongoing project initiated by Acting Chairman Lukken last summer is a special call survey of swap dealers and index traders through which the Commission has attempted to determine the total amount of commodity index trading occurring in both the OTC and exchange markets, the types of counterparties—commercial or noncommercial—who utilize swap dealers and whether their positions would exceed speculative limits or accountability levels had they been entered into on-exchange. Commission staff released a report last September describing their preliminary findings.

Based on these preliminary findings, staff did not find a direct connection between index trading and rising prices. Nor did staff find evidence of a substantial amount of trading that would have exceeded position limits or accountability levels had it been conducted on-exchange. Staff emphasized the need for greater transparency regarding the activities of index traders and swap dealers, however, and recommended the development of enhanced data collection and reporting procedures, as well as the publication of periodic supplemental reports quantifying the amount and type of trading done through swap dealers, including index trading. I am pleased to announce the Commission will soon publish a report which includes data from the last two quarters of 2008 as well as the first quarter of 2009. This process is on-going and we will continue to collect, analyze and publish this important data.

A related recommendation by the staff was to review whether to eliminate the *bona fide* hedge exemption for swap dealers and create a new limited risk management exemption based on the nature of their clients. Pursuant to this recommendation, in March the Commission published a concept release requesting comment on fifteen questions related to this subject. The comment period has been extended to June 22nd and I encourage all of you who are interested to give us your views.

Another proposal out for public comment would amend Commission Rule 1.17 to raise the amount of minimum adjusted net capital that must be maintained by a futures commission merchant (FCM) from $250,000 to $1,000,000, and the minimum adjusted net capital for nonguaranteed introducing brokers from $30,000 to $45,000. The proposal also addresses amendments to the calculation of risk-based capital requirements and the inclusion of computations for cleared OTC positions carried in the customer, noncustomer, and proprietary accounts of FCMs similar to the computations currently required for exchange-traded futures. The proposed amendments would apply to OTC derivatives carried in accounts on the books of the FCM that are cleared by either a U.S. derivatives clearing organization or a foreign clearinghouse. Finally, under current regulations FCMs that are also securities brokers and dealers (BDs) must compare the minimum amounts of capital required under the SEC's and CFTC's regulations and to maintain capital in excess of whichever amount is greater. The proposal solicits comments on the advisability of requiring BD/FCMs to maintain the sum of these amounts rather than the greater of these amounts. Comments on these proposals must be received by July 6th.

Through an advance notice of proposed rulemaking published May 22nd, the Commission is also soliciting comment on the rules governing the investment of customer segregated funds set forth in Commission Regulation 1.25. Under the CEA, the investment of such funds is limited to U.S. government and municipal securities. Pursuant to its exemptive authority, however, the Commission substantially expanded the list of permissible investments over the past decade to include, among other things, government sponsored enterprise securities, bank certificates of deposit, commercial paper, corporate notes, the general obligations of sovereign nations, and interests in money market mutual funds. In 2007, Commission staff launched a review of the nature and extent of investments of segregated funds, as well as Rule 30.7 secured amounts, to obtain a better understanding of investment practices and to assess whether changes to the regulations were warranted. This review was still ongoing in September 2008 when, among other things, shares in the Reserve Primary Fund—one of the largest money market mutual funds—fell below $1 and redemption requests were frozen for seven days. The dramatic change in the financial landscape has illustrated the need for periodic reassessments of permissible investments to ensure that customer funds are held in safe, liquid vehicles and are readily available upon demand. As a part of this review the Commission is seeking comment on whether similar standards should apply to customer money, securities and property associated with positions in foreign futures and foreign options under Commission regulation 30.7.

In December of 2008 the CFTC created a Task Force to identify issues and to develop ideas for responding to recent financial market events. Staff is collaborating to develop recommendations for proposals to enhance the CFTC's responsiveness to ongoing regulatory challenges. The Task Force includes representatives from all of our operating Divisions, and has focused on two areas:

The Task Force's first project examined the impact of the Lehman bankruptcy and identified domestic and cross-border issues and challenges faced by the futures industry. The group concentrated primarily on issues of financial integrity and stability, with an emphasis on safeguarding customer funds. In February 2009, the Acting Chairman approved all of the Task Force recommendations on ways for the CFTC to enhance its regulatory program.

The Task Force currently is working on an extensive contingency plan for addressing financial difficulties that potentially could affect FCMs. This plan is intended to document the CFTC's existing approach. Among other things, the contingency plan sets forth several protocols and accompanying issues to be addressed and provides guidance on possible regulatory action that may be taken by the Commission. The paper also addresses coordination with other regulatory authorities.

Building on our domestic initiatives, the CFTC is coordinating its approach on an international level. This week, at the annual meeting of the International Organization of Securities Commissions (IOSCO), two mandates arising out of the Lehman failure were approved.

In the first initiative, IOSCO will focus on the issue of customer fund protection of an insolvent intermediary. Under the mandate, IOSCO will conduct a survey designed to elicit information on the current legal framework under the insolvency laws for the treatment of client property.

In addition, IOSCO has approved a mandate relating to suitability standards applicable to the sale of complex products. This mandate arises specifically as a result of so-called Lehman mini-bonds that were apparently distributed to retail investors in Asia and Europe through questionable sales practices.

Lastly, the Commission's Division of Clearing and Intermediary Oversight has recently undertaken a broad review of the 30.10 program. Under Regulation 30.10, the Commission may exempt a foreign firm acting in the capacity of an FCM from compliance with certain Commission regulations, including those regulations pertaining to registration, provided that a comparable regulatory system exists in the firm's home country and that certain safeguards are in place to protect U.S. customers. Since 1988, the Commission has issued Regulation 30.10 orders to foreign regulators and exchanges in 11 foreign countries.

In this general review, the Division plans to examine both the process by which petitions are evaluated, and the procedures for monitoring the program going forward.

Needless to say, my tenure at the Commodity Futures Trading Commission has been a busy one. I am honored to be here in London with all of you and to have the opportunity to share some of the developments of the U.S. futures regulatory agency.