The Commodity Futures Trading Commission: Background and Current Issues

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Summary

The 113th Congress is interested in an array of issues faced by the Commodity Futures Trading Commission (CFTC). The congressional committees with oversight of the agency, the House and Senate Agriculture Committees, have begun to hold hearings related to various policy issues faced by the agency, as part of the CFTC reauthorization process. This process occurs roughly every five years and is currently underway, as the last authorization of appropriations for the agency expires September 30, 2013.

The CFTC witnessed a major expansion of its role in overseeing derivatives markets following passage of the Dodd-Frank Act in 2010. This act brought previously unregulated over-the-counter (OTC) derivatives, called swaps, under the oversight of the CFTC. The new role of the CFTC as a regulator of the swaps markets comes in addition to its preexisting role overseeing the futures and options markets, which include commodities and financial market instruments such as interest rate futures. Under the Dodd-Frank Act, much discretion on a range of key issues related to the new regulation of swaps was left to the CFTC (and to the Securities and Exchange Commission for swaps based on securities).

As the agency seeks to use its rulemaking powers to implement Dodd-Frank, several issues are proving challenging or contentious. These include the CFTC’s and other financial regulators’ implementation of the Volcker rule under Section 619 of Dodd-Frank, which prohibits proprietary trading and hedge fund activities by banks. Other Dodd-Frank implementation issues have prompted legislation in the 113th Congress. H.R. 677 addresses the scope of an exemption from clearing requirements for swaps between affiliates within an umbrella organization. A related issue is determining the scope of any exemption from the Dodd-Frank Act requirements on swaps for overseas branches or affiliates of U.S. organizations and for foreign organizations trading with U.S. persons—an issue that H.R. 1256 seeks to address. H.R. 1256 passed the House on June 12, 2013, in a roll call vote of 301-124. Another bill, H.R. 634, which also passed the House on June 12 in a roll call vote of 411-12, would prevent regulators from imposing margin requirements on swaps for both counterparties in which one counterparty is a non-financial firm, known as an “end user” of derivatives. H.R. 1003 would mandate additional cost-benefit analyses by the CFTC when it conducts future rulemakings.

In addition, changing technologies have created novel challenges for the agency’s oversight in such matters as monitoring high frequency trading in the derivatives markets. Furthermore, certain failures, such as the collapse of the futures trading firms MF Global and of Peregrine Financial, and enforcement issues, such as the manipulation of LIBOR, have flagged policy issues for the CFTC on the enforcement and policy fronts. Commodity price volatility, such as in the 2008 and 2011 runups in oil prices, has also sparked congressional interest in the CFTC’s proposed position limits rule, which some hope would constrain volatility in these markets. The CFTC’s position limits rule was vacated and remanded by a federal court in 2012—a decision that the CFTC has appealed.

This report provides summaries and abbreviated analyses of selected issues faced by the CFTC that may be relevant to the 113th Congress. It is not an exhaustive list of issues facing the agency. The appendix offers detailed background information on derivatives markets and related policy issues addressed in the Dodd-Frank Act. This report will be updated as events warrant.
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History and Functions of the CFTC

The Commodity Futures Trading Commission (CFTC) was created in 1974 through enactment of the Commodity Futures Trading Commission Act¹ to regulate commodities futures and options markets, which at the time were poised to expand beyond their traditional base in agricultural commodities to encompass contracts based on financial variables, such as interest rates and stock indexes. The CFTC’s mission is to prevent excessive speculation, manipulation of commodity prices, and fraud. The agency administers the Commodity Exchange Act (CEA),² which was passed in 1936. Prior to the CFTC’s creation, trading in agricultural commodities regulated by the CEA was overseen by an office within the U.S. Department of Agriculture called the Commodity Exchange Administration, which was also formed in 1936.

The CFTC oversees industry self-regulatory organizations (SROs)—the futures exchanges and the National Futures Association—and requires the registration of a range of industry firms and personnel, including futures commission merchants (brokers), floor traders, commodity pool operators, and commodity trading advisers. Since passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act),³ the CFTC’s jurisdiction has expanded significantly to include over-the-counter (OTC) derivatives, also called swaps. As a result of Dodd-Frank, major participants in the swaps markets are required to register with the CFTC, and certain swaps are required to be cleared by clearinghouses. Such newly regulated swap market participants include swap dealers, major swap participants, swap clearing organizations, swap execution facilities, and swap data repositories. These entities are subject to new business conduct standards contained in the statute or promulgated as CFTC rules. Like the Securities and Exchange Commission (SEC), the CFTC does not directly regulate the safety and soundness of individual firms, with the exception of newly regulated swap dealers and major swap participants, for whom it will set capital standards pursuant to Dodd-Frank.

Although most derivatives trading these days relates to financial variables (interest rates, currency prices, and stock indexes), congressional oversight remains vested in the House and Senate Agriculture Committees in part because of the market’s historical origins in agricultural commerce. Appropriations for the CFTC are under the jurisdiction of the Agriculture Appropriations Subcommittee in the House and the Financial Services and General Government Appropriations Subcommittee in the Senate.

To meet additional responsibilities for oversight of swaps, the Obama Administration has requested additional funding for the CFTC since FY2011. For FY2011, P.L. 112-10 provided $202 million for the CFTC, up 20% from the $169 million provided for FY2010 before enactment of the Dodd-Frank Act. For FY2012, the President requested $308 million, or $105 million more than FY2011 enacted appropriations. For FY2012, P.L. 112-55 provided $205.3 million for the CFTC, an increase of $3.3 million over FY2011. This amount was $33.3 million more than the House recommended, but $34.7 million less than the Senate Appropriations Committee’s recommendation, and about $103 million (33%) below the Administration’s request. For FY2013, the Administration again requested $308 million. The enacted amount in P.L. 113-6 was a constant $205.3 million, but across-the-board rescissions reduced that amount to about $199.7 million. For FY2014, the Administration is requesting $315 million. The House Appropriations Subcommittee on Agriculture, Rural Development, Food and Drug

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¹ P.L. 93-463.
² P.L. 74-765, 7 U.S.C. §1 et seq.
³ P.L. 111-203.
Administration and Related Agencies approved a bill that would provide $194.6 million for the CFTC. Senate action on FY2014 appropriations has not yet occurred. For more on CFTC appropriations, see CRS Report R42596, Agriculture and Related Agencies: FY2013 Appropriations, by Jim Monke.

Organizationally, the CFTC is led by five commissioners appointed by the President, with the advice and consent of the Senate, to serve staggered five-year terms. No more than three commissioners at any one time may be from the same political party. The President designates one commissioner to serve as chair. The agency is organized around four divisions:

- Clearing and Risk, which oversees derivatives clearing organizations and other major market participants;
- Enforcement, which investigates and prosecutes alleged violations of the Commodity Exchange Act and of CFTC regulations;
- Market Oversight, which conducts trade surveillance and oversees trading facilities such as futures exchanges; and
- Swap Dealer and Intermediary Oversight, which oversees registration and compliance by self-regulatory organizations (SROs), such as the futures exchanges (e.g., the Chicago Mercantile Exchange), the National Futures Association, and registration of swap dealers and major swap participants.

Current Issues

The CFTC currently faces a range of issues—many of them related to the many rulemakings it was charged with under the Dodd-Frank Act regarding bringing the swaps market under regulation. Other issues relate to the CFTC’s role in overseeing the derivatives markets. Some CFTC rulemakings have generated criticism from market participants, the financial industry, Members of Congress, or foreign regulators. What follows are some of the major issues that have sparked debate or spurred legislation, as well as other enforcement issues and additional challenges. It is a selective, not exhaustive, list.

Dodd-Frank Act Implementation Issues

Cross Border Swaps and Extra-Territoriality

This topic relates to the question of to what degree did Congress intend, and did the Dodd-Frank Act authorize, the CFTC to regulate swaps that may extend beyond U.S. borders, or be transacted between U.S. and non-U.S. persons? Because the swaps market is international in nature, with considerable cross-border trading, this question is material. Section 722(d) of the Dodd-Frank Act stated that swaps reforms shall not apply to activities outside the United States unless the activities have “a direct and significant connection with activities in, or effect on, commerce of the United States.”

This mandate left much discretion to the CFTC as to how to interpret it. CFTC Chair Gary Gensler has stated that “Failing to bring swaps market reform to transactions with overseas branches and overseas affiliates guaranteed by U.S. entities would mean American jobs and markets would likely move offshore, but, particularly in times of crisis, risk would come crashing

4 P.L. 111-203, Title VII, §722(d).
back to our economy.” To give some practical examples, Gensler and others have noted that derivatives trading by overseas affiliates of U.S. financial conglomerates can and has resulted in significant losses to the U.S.-based entity. They cite examples such as American International Group Inc.’s (AIG’s) London-based Financial Products Group, which sold credit default swap derivatives related to mortgage-backed securities that incurred losses during the financial crisis, or the more recent J.P. Morgan “London Whale” derivatives trading losses of roughly $6 billion.

On the other hand, industry participants have warned that if the CFTC proposed rule were not modified or postponed, then “swap business will migrate, in the short term, away from U.S. financial institutions to other jurisdictions that are putting in place similar regulatory reform initiatives but are not as far advanced in doing so as the United States”—and have warned that, once gone, such business is unlikely to return.

The CFTC issued proposed guidance on the cross-border application of Title VII of Dodd-Frank. In it, the agency sought to clarify who would count as a “U.S. person” for the purposes of meeting the requirements of Dodd-Frank, such as the clearing requirement for swaps, among other questions. More recently, on December 21, 2012, the agency issued a temporary exemption, extending the deadline for meeting all the requirements for cross-border swaps, while the CFTC continued to try to work with foreign regulators to create a more uniform system of requirements. Then, on May 1, 2013, the SEC proposed a rule and interpretive guidance on cross-border “security-based swaps”—swaps related to a security, such as an equity—which the SEC regulates. The SEC’s proposed rule has been widely interpreted as taking a narrower approach to defining who is a “U.S. person” than did the CFTC—and thus restricting the reach of Dodd-Frank requirements on security-based swaps to fewer overseas transactions or entities.

In addition, legislation was passed by the House (H.R. 1256) on June 12, 2013, which would mandate that the CFTC and SEC issue joint, identical rules “relating to cross-border swaps and security-based swaps transactions involving U.S. persons or non-U.S. persons.” The legislation, if enacted, thus would likely supersede the proposed CFTC and SEC rules on cross-border swaps. Instead, the CFTC and SEC would be required to jointly introduce a new proposed rule on cross border swaps. Also, H.R. 1256 requires the CFTC and SEC to allow non-U.S. persons in compliance with the laws of any countries with one of the nine largest swaps markets to be exempt from U.S. regulatory requirements on swaps, unless the two agencies issue a joint rule

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6 Ibid.


11 H.R. 1256 §2(a)(1).
finding that the regulatory requirements of any of these nine countries or administrative regions “are not broadly equivalent to U.S. swaps requirements.”

In House floor debate, opponents of the bill asserted that it would weaken the Dodd-Frank requirements on swaps by allowing foreign banks and overseas affiliates of large U.S. conglomerates to escape these swaps requirements, and that it would slow down the pace of agency rulemakings and implementation of the Dodd-Frank derivatives reforms. Supporters of the bill stated that it would subject U.S. and foreign businesses to harmonized U.S. swaps requirements, and avoid potentially conflicting regulations between U.S. and overseas jurisdictions, thereby reducing the regulatory burden on businesses.

Prior to passage, H.R. 1256 was marked up and ordered reported out of the House Agriculture Committee on March 20, 2013, and then was marked up and reported out of the House Financial Services Committee on May 7, 2013. H.R. 1256 was passed by the House on June 12, 2013, with a roll call vote of 301 to 124.

**Margin for Non-Financial Entities or “Commercial End Users”**

In the Dodd-Frank Act, a key provision was a requirement that swap contracts be cleared through a clearinghouse (or “central counterparty”) regulated by one or more federal agencies. Clearinghouses require traders to put down cash (called initial margin) at the time they open a contract to cover potential losses, and they require subsequent deposits (called maintenance margin) to cover actual losses. Margin requirements can help safeguard against the possibility that any firm can build up an undercapitalized exposure so large that default would have systemic consequences. One well-known example of such an undercapitalized exposure is the case of AIG, which sold about $1.8 trillion worth of credit default swaps guaranteeing payment if certain mortgage-backed securities defaulted or experienced other “credit events.” When derivatives are cleared, the size of a cleared position is limited by the firm’s ability to post capital to cover its potential losses. That capital protects its trading partners and the system as a whole.

While the clearing of derivatives helps to address systemic concerns, it also imposes the cost of posting margin on those who trade derivatives. For example, if a grain farmer uses a futures position to hedge against the possibility that grain prices might eventually fall, then for the duration of the time that his futures position is open, he may be required to post additional cash or liquid securities to cover unrealized losses in that position. This is true even if the futures position ultimately makes the farmer a profit when it is closed out. In this case, any excess margin is returned to the grain farmer—but he still incurs temporary borrowing costs to come up with margin, and these costs can potentially be high. Many nonfinancial firms complained during the debate over the Dodd-Frank Act that their use of derivatives posed no systemic threat and thus

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12 H.R. 1256 §2(d)(1).
15 The final vote results for roll call vote 218—the vote on H.R. 1256—including 228 Republicans voting in favor of passing the bill; 73 Democrats voting in favor; 2 Republicans voting against passage of the bill; and 122 Democrats voting against passage.
16 For further details on credit default swaps, a type of OTC derivative, and how they work, please see CRS Report RS22932, Credit Default Swaps: Frequently Asked Questions, by Edward V. Murphy and Rena S. Miller.
they should not be subjected to the cost of clearing these OTC derivatives. For additional information on clearing and how it works, please see the Appendix.

This particular debate came to be known as “the end user debate,” as it referred to so-called “end users” of derivatives. As a result of these concerns, the Dodd-Frank Act in Section 723 includes a broad exemption from the clearing requirement for firms that are primarily non-financial in nature. Nevertheless, non-financial firms have continued to be concerned that the act could impose indirect costs on them, or that the rulemaking process by the CFTC, SEC, or prudential bank regulators could do so. In the 113th Congress, legislation (H.R. 634) has been proposed to address these concerns. H.R. 634 would prevent regulators from imposing margin requirements on swaps for both counterparties in which one counterparty is an “end user.” H.R. 634 was marked up and reported out of the House Agriculture Committee on March 20, 2013, and then by the House Financial Services Committee on May 7, 2013. On June 12, 2013, H.R. 634 was passed by the House with a roll call vote of 411 to 12. In the Senate, an identical companion bill, S. 888, was introduced by Senator Johanns on May 7, 2013, co-sponsored by Senator Warner and 13 others. On May 8, 2013, S. 888 was read the second time and placed on the Senate legislative calendar under general orders.

Application of Dodd-Frank Title VII to Swaps Between Corporate Affiliates

Another area that has sparked industry calls for exemptions, and for which legislation has been introduced in the 113th Congress (H.R. 677), is the question of the extent to which swaps between affiliates within an umbrella organization, such as a financial or corporate conglomerate, should be subject to the clearing and other requirements of Dodd-Frank. At issue is the question of whether derivatives trading between affiliates within a large umbrella organization could pose substantial risks of losses to either affiliate, or spread losses outside the organization. In addition, there is the question of what, if any, risks might be posed within the conglomerate between affiliates’ swap trading. For instance, might one affiliate have an incentive to gain through a swaps trade at another affiliate’s expense? What repercussions could this have within the conglomerate? And what is the best way to control risks of excessive losses by one affiliate from such trades? Proponents of greater exemptive relief have argued that losses within a parent organization, from trading between affiliates, would pose little or no risk outside the organization. They further argued that it would be unduly costly for affiliates to be forced to clear, and thereby post margin payments for, swaps transacted between the affiliates.

The CFTC issued a proposed rule on August 16, 2012, exempting certain inter-affiliate swaps from the requirements of Title VII of the Dodd-Frank Act, and a final rule on April 1, 2013. The CFTC argued in its final rule that it “is not persuaded by comments suggesting that inter-

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17 It should be noted that end users’ counterparties are often financial firms, and because they are trading with an end user, the financial firm would also be exempt from clearing and posting margin for these transactions.


affiliates swaps pose no risk to the financial system.”

This is because entities that are affiliated with each other remain separate legal entities notwithstanding that affiliation, and as such, are not legally responsible for one another’s debts or losses, the CFTC stated. The CFTC further warned that while AIG’s collapse was not caused by swaps traded within its affiliates, the events surrounding AIG’s near-collapse demonstrated how the risks of uncleared swaps at one affiliate could have important ramifications for the entire affiliated business group.

(For more on AIG’s swaps activities and the financial crisis, see the Appendix.) To address such risks, the CFTC’s final rule limits the inter-affiliate exemption to cases in which the affiliates are majority owned and their financial statements are consolidated. In addition, the affiliates must be subject to a centralized risk management program. Further, the swaps and the trading relationship between the affiliates must be documented, and any outward-facing swaps (i.e., with parties not affiliated), must be cleared or else qualify for an exemption from the clearing requirement.

H.R. 677 would create a statutory exemption from the Dodd-Frank requirements for certain swaps between affiliates, provided that neither affiliate is also a “swap dealer that is an insured depository institution”—among other restrictions. H.R. 677 was marked up and ordered to be reported out of the House Agriculture Committee on March 20, 2013, and then marked up and ordered to be reported out of the House Financial Services Committee on May 7, 2013.

Proponents of H.R. 677 have argued that regulatory requirements on swaps between affiliates within an umbrella organization can be burdensome, and that such swaps pose little risk to external parties. Critics of H.R. 677 have argued that the CFTC final rule already addressed industry concerns over reducing the regulatory burden on inter-affiliate swaps; that large corporate conglomerates can have thousands of subsidiaries; and that in the case of the bankruptcy of a subsidiary, assets overseas may not be available to U.S. investors; and expressed concerns that the bill could provide a loophole from the Dodd-Frank Act’s clearing requirement.

**The Volcker Rule**

Section 619 of the Dodd-Frank Act is commonly referred to as the Volcker Rule, after Paul Volcker, former chairman of the Board of Governors of the Federal Reserve System. It prohibits banking entities from engaging in proprietary trading or sponsoring certain classes of funds, such as hedge funds or private equity funds, which speculate in financial markets. Section 619’s

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21 78 FR 21749 at 21752.
22 Ibid at 21752.
23 Ibid at 21752.
24 Ibid at 21753.
28 Under the statute, “proprietary trading” is “engaging as principal for the trading account of the banking entity ... in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity or contract, or any other security or financial instrument that the appropriate [agency] may, by rule ... determine.” 12 U.S.C. §1851(h)(4).
prohibition of proprietary trading attempts to prevent bank holding companies whose depository banks have access to the taxpayer-assisted safety net from speculating in financial markets.  

However, it can be difficult to distinguish between a bank speculating for itself, versus a bank acting on behalf of customers or a bank hedging to improve safety and soundness. This has been a challenge faced by regulators charged with implementing the Volcker rule, of which the CFTC is one. The CFTC issued its proposed rule implementing Section 619 of Dodd-Frank on February 14, 2012.  

Its proposed rule, according to the CFTC, is substantially similar to the Volcker rule proposed jointly by the Board of Governors of the Federal Reserve System (Fed); the Office of the Comptroller of the Currency (OCC); the Federal Deposit Insurance Corporation (FDIC); and the SEC in October of 2011. The CFTC’s ongoing effort to finalize its Volcker rule, in conjunction with these other regulators, continues to pose a challenge to the CFTC and to the other regulators. This is particularly the case as the proposed rule has faced criticisms both that it is too strict, lengthy, and burdensome; and also, from proponents of financial reform, that it does not go far enough to prevent banks from proprietary trading, such as derivatives trading.

How Will Swaps Be Traded? The Question of Swap Execution Facilities

Under the Dodd-Frank Act, those swaps traded by financial entities that are required to be cleared are also required to be traded on an exchange or an exchange-like “swap execution facility” (SEF). The SEF is regulated by either the CFTC or the SEC in the case of security-based swaps. The goal of this requirement is to promote more price transparency in the swaps markets. Such swap trades must also be reported to data repositories so that regulators will have complete information about all derivatives positions. Data on swap prices and trading volumes must be made public. The CFTC proposed a rule on January 7, 2011, on “Core Principles and Other Requirements for Swap Execution Facilities,” and after a lengthy comment period, issued a final rule on May 16, 2013, regarding what such SEFs must look like. A broad challenge for the CFTC in designing a final rule was the tradeoff between promoting transparency and disrupting the existing swap market. Traditionally, and prior to the Dodd-Frank Act, when one wanted to trade a swap, one would phone a large financial institution that was a swap dealer, and the dealer would quote a price for trading that swap. By contrast, a futures exchange or options exchange publishes prices throughout the day for contracts offered for trading. Although exchanges promote price transparency, some customized or illiquid swaps may be too lightly traded and non-standardized to be suitable for exchange trading. Thus, the concept of “swap execution facilities” was introduced in the Dodd-Frank Act to refer to multilateral swap trading platforms that had some degree of pre-trade and post-trade price transparency but were not exchanges. Discretion was left to the CFTC to determine what a SEF should look like.

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30 77 Federal Register 8332.
Legislation in the 112th Congress (H.R. 2586, introduced by Representative Scott Garrett) sought to amend the definitions of SEF and security-based swap execution facility (SBSEF) in the Dodd-Frank Act. The issuance of the CFTC’s final rule on “Core Principles and Other Requirements for Swap Execution Facilities,” although opposed by at least one industry group,35 may resolve some of these questions. No legislation on SEFs has been introduced in the 113th Congress.

Market Oversight Issues

The Position Limits Rule and Commodity Price Volatility

Concern about derivatives trading has been fueled by periodic sharp rises in commodity prices—particularly oil. For instance, during the course of 2008 oil prices doubled to more than $145 per barrel and then fell by 80%, before rebounding again, while there was little actual interruption of physical supplies. In early 2011, there was again a run-up of about 20%, sending gasoline prices near 2008 highs. Such steep jumps, along with unexplained price volatility in a range of commodities, have fostered apprehension that financial speculation in derivatives might be creating such volatility in commodity prices.36

The role of speculators37 in oil and commodities markets has attracted congressional interest. For example, in 2009 the staff of the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs found that excessive speculation had “undue” influence on wheat price movements38 and in the natural gas market.39 A 2011 report by the minority staff of the House Committee on Oversight and Government Reform argued that “addressing excessive speculation offers the single most significant opportunity to reduce the price of gas for American consumers.”40 Economists remain divided, however, on the question of whether financial trading in derivatives contributes to increased commodity price volatility.

Against this backdrop, attention has turned to the CFTC’s attempt under Dodd-Frank to impose what are known as “position limits” on a range of commodities, including energy products. Position limits are intended to constrain the size of a derivatives position that can be taken by any single speculator. (Exemptions exist for what are termed “commercial hedgers”—i.e., those who tend to engage in the physical production or delivery of a commodity.) The limits often take one of two forms: either a ceiling on the number of contracts that a speculator may control or an

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36 For a further examination of the role financial speculation may play in commodity prices, see CRS Report R41986, Speculation, Fundamentals, and Oil Prices, by Rena S. Miller.
37 Speculators are basically investors who seek to profit by betting on which way prices will move. They are often contrasted with commercial firms trading derivatives to hedge future risks.
“accountability level”—a position size threshold beyond which traders must explain to the futures exchange why they have such a large position (and reduce the position if the exchange so orders).

Before the enactment of Dodd-Frank, the CFTC had authority to set position limits for speculators on the futures exchanges. In practice, however, the CFTC established limits for only about a dozen agricultural contracts, and delegated to the exchanges the task of setting limits for the hundreds of other futures contracts. Section 737 of the Dodd-Frank Act appeared to direct the CFTC to establish position limits for swaps and futures. The CFTC approved rules setting position limits for certain commodities in November of 2011. Industry groups challenged the regulations in court, arguing that the rules issued by the CFTC violated the Commodity Exchange Act because the CFTC had not conducted the appropriate analysis to determine whether the rules were necessary and appropriate prior to issuing the rules.

The U.S. District Court for the District of Columbia vacated and remanded the CFTC’s position limit rules in a decision issued in September of 2012. The court held that the agency had erroneously found the statute to be unambiguous in directing the CFTC to impose position limits, whereas the court found Section 737 of Dodd-Frank to be ambiguous in that regard. On November 15, 2012, the CFTC announced it would appeal the district court’s decision to vacate the rule.

### Issues Arising from the MF Global and Peregrine Failures

On October 31, 2011, MF Global, a large brokerage firm registered with the SEC as a broker-dealer and with the CFTC as a futures commission merchant (FCM), filed for bankruptcy, after what appeared to be a “run on the bank” due to concerns over its exposures to European sovereign debt. Although futures customers’ funds were supposed to be “segregated,” and thus essentially safe from the bankruptcy process, roughly $1 billion in customer funds were reported missing soon after the bankruptcy. By February 2013, about 16 months later, however, roughly 93% of customer funds had reportedly been returned, following a lengthy bankruptcy process.

The MF Global failure raised questions about whether enforcement mechanisms for segregation of futures market customer funds were reliable—particularly in times of unusual stress. It also provided an opportunity to evaluate the effectiveness of regulatory cooperation during a rapid failure of a large, complex financial institution. It prompted a number of policy questions: is the enforcement of segregation requirements for futures customers’ accounts sufficient for unusual market conditions, such as a run? Should some type of SIPC-like insurance, such as is offered by the Securities Investor Protection Corporation (SIPC), which provides an insurance scheme whereby customers of failed broker-dealers may receive up to $500,000 from the SIPC fund.

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41 Codified at 7 U.S.C. §6a(a).
46 For more details on the MF Global failure, see CRS Report R42091, The MF Global Bankruptcy and Missing Customer Funds, by Rena S. Miller.
48 Securities broker-dealers must belong to the Securities Investor Protection Corporation (SIPC), which provides an insurance scheme whereby customers of failed broker-dealers may receive up to $500,000 from the SIPC fund.
for customers of securities broker-dealers, be contemplated for futures customers, or would costs be too great? There is no analogue to SIPC in futures markets regulated by the CFTC. There are strict rules about the use of customer funds, however. Section 4d(a)(2) of the CEA requires that customer funds received by an FCM to margin, guarantee, or secure a customer’s futures contracts be held in segregated accounts, and not be commingled with the funds of the FCM itself, nor used to guarantee the trades or contracts of any person other than the customer.49 Thus, any MF Global losses related to its own proprietary trading should not have affected customers.

Also, on January 31, 2013, Russell Wasendorf Sr., the founder and former CEO of Peregrine Financial Group Inc., a futures trading firm, was sentenced to 50 years in prison after being convicted of stealing more than $215 million from customers of that failed brokerage. The failure of Peregrine in July 2012, and subsequent loss of futures customers’ funds, further underscored the need to revisit whether measures to protect futures customers’ funds were adequate. The National Futures Association (NFA), the self-regulatory organization, came under criticism for failing to catch a shortfall in customer segregated account funds even though it was the front-line auditor of Peregrine.50

In response to the MF Global and Peregrine failures, the CFTC on November 14, 2012, proposed a rule51 aimed at increasing disclosure requirements for futures brokers to give customers greater accounting for their funds. The proposal arguably would require heightened disclosure by brokers about how client collateral is held at custodial banks.52 Standards for auditors of brokerages would also be increased under the rule.53 Industry groups, however, have complained that the proposed rule would impose excessive costs.54 The CFTC, in finalizing its proposed rule, would presumably weigh industry concerns that stricter safeguards could tie up additional capital and raise costs for futures customers with the policy goals of improving protections for customer funds.

**Manipulation of LIBOR**

The London Interbank Offer Rate (LIBOR) is an estimate of prevailing interest rates in London money markets determined by a survey of large banks, and is commonly referenced in many financial contracts, including interest rate futures contracts in 10 currencies.55 Barclays, a British bank that serves on the panel responding to the LIBOR survey, admitted submitting false survey responses to manipulate the index and attempting to manipulate a similar index, the Euro Interbank Offer Rate (EURIBOR).56 The CFTC and the U.S. Department of Justice (DOJ)  

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49 However, §4d(f)(3)(A) of the CEA does provide an exception permitting commingling “for convenience.”


53 Ibid.


56 For more detail on LIBOR-related issues, see CRS Report R42608, *LIBOR: Frequently Asked Questions*, by Edward V. Murphy.
reached settlements with Barclays in which the bank agreed to admit fault and pay a large fine. Subsequently, two more large banks—UBS and Royal Bank of Scotland—have also entered into settlements with the U.S. government, with government fines totaling approximately $2.5 billion.\(^{57}\) These fines include civil monetary penalties to the CFTC of more than $1.2 billion in penalties from these banks, related to manipulation of LIBOR.\(^{58}\) In the wake of the settlements and continuing private litigation over alleged manipulation of LIBOR by a number of large banks, CFTC Chair Gensler has publicly called for reforms to how LIBOR is calculated, to make the rate more closely tied to actual transactions, rather than based on surveys of bankers’ stated expectations of their anticipated lending costs.\(^{59}\) Reforms to LIBOR as a benchmark interest rate are also underway in the UK.

**High Frequency Trading**

The term *high frequency trading* (HFT) generally refers to computerized trading based on algorithms in which transactions are completed in very small fractions of a second.\(^{60}\) HFT is conducted through supercomputers that give firms the capability to execute trades within milliseconds. High frequency traders submit and cancel a massive number of orders and execute a large number of trades, trading in and out of positions very quickly.\(^{61}\) The TABB Group, a financial market consulting firm, reportedly estimated that such HFT comprised over 60% of all futures volume in 2012 on U.S. futures exchanges.\(^{62}\)

By various accounts, the proportion of trades on the futures exchanges attributable to HFT has grown briskly during the last few years.\(^{63}\) Proponents of HFT have argued that the rise of HFT has tended to increase market liquidity and narrow bid-ask spreads,\(^{64}\) thereby reducing transaction costs.\(^{65}\) Yet, HFT has raised concerns about fairness in trading and also about market stability more generally. For instance, do hedge funds and large investment banks, who can afford the latest technology, have an advantage over small investors? Do institutions that serve small investors, such as mutual funds or pension funds, pay more (or receive less) for futures contracts or stocks because HFT traders may interpose themselves between ultimate buyers and sellers?


\(^{64}\) The bid-ask spread is the difference between what a dealer will pay for a security and the price at which it is willing to sell the same security. Wider spreads are equivalent to higher transaction costs for investors.

Such concerns have percolated in the press and among market participants and regulators.66
Regulators at the CFTC have also expressed concerns over the possible use of HFT to flood a
market with “wash trades,” which are bids and offers launched essentially by the same market
participant to create the impression of greater market activity, even though the participant incurs
no actual market risk.67 The Commodity Exchange Act prohibits wash trades.68 According to
media reports, the CFTC is investigating whether HFT at times floods markets with such wash
trades to influence prices or trading volumes for short periods of time so certain HFT traders
could profit.69

Another issue is the impact of HFT on market stability. During the afternoon of May 6, 2010, the
stock market lost about 6% of its value (equivalent to a 700-point drop in the Dow Jones
Industrial Average) for about five minutes, and then made up nearly all of the loss. A joint study
by the SEC and the CFTC attributed this “flash crash” to a single mutual fund’s trading
algorithm, which continued to sell after all buying interest was exhausted.70 More recently, on
August 1, 2012, HFT firm Knight Capital Group Inc. lost about $440 million in less than an hour,
and its stock plunged 73%, after a computer malfunction bombarded the stock market with errant
orders.71 The incident further underscored concerns over potential impacts on market stability
from any HFT technical trading problems.

The CFTC oversees trading, including HFT, on futures exchanges such as the Chicago Mercantile
Exchange (CME) and Intercontinental Exchange (ICE). The SEC oversees HFT for securities
markets. In addition to reportedly investigating potential wash trades related to HFT, the CFTC
regularly holds meetings of its Technical Advisory Council (TAC). In February 2012, the TAC
created a Subcommittee on Automated and High Frequency Trading which includes CFTC and
industry participants and examines various HFT trading practices.72

In addition, on May 16, 2013, the CFTC issued an interpretive guidance on disruptive trading
practices, which touches on issues that may involve HFT.73 Section 747 of the Dodd-Frank Act74
amended the Commodity Exchange Act (CEA) to prohibit disruptive trading practices in futures,
options, or swaps trading. Among other changes, the amended CEA Section 4c(a)(5) outlaws
“spoofing”—bidding or offering with the intent to cancel the bid or offer before executing a trade.
One study of HFT by the Swedish financial regulatory authority in 2012 found that spoofing was

Investor Relations. Available at http://www.insideinvestorrelations.com/articles/disclosure-regulation/19327/sec-bring-
new-rules-monitor-high-frequency-trading/.

67 The CFTC Glossary defines wash trading as “Entering into, or purporting to enter into, transactions to give the
appearance that purchases and sales have been made, without incurring market risk or changing the trader’s market


69 Scott Patterson, Jenny Strasburg And Jamila Trindle, “Wash Trades Scrutinized,” The Wall Street Journal, March 22,

70 Findings Regarding The Market Events Of May 6, 2010: Report Of The Staffs Of The CFTC And SEC To The Joint


72 See CFTC Technical Advisory Committee Sub-Committee on Automated and High Frequency Trading, Working

73 Commodity Futures Trading Commission, “Antidisruptive Practices Authority,” 78 Federal Register 31890, May 28,
2013.

74 P.L. 111-203.
associated with HFT, at least in the experiences of traders, and that market participants believed it was being used to manipulate the prices for some financial instruments.\(^75\) In its May 2013 guidance, the CFTC prohibited spoofing on any futures exchange or swap execution facility as long as the canceling of the bids and offers before trade execution was intentional, rather than the result of reckless, negligent, or accidental behavior.\(^76\) Also, the guidance prohibits a person from buying a derivatives contract on an exchange or swap execution facility “at a price that is higher than the lowest available price offered for such contract or selling a contract ... at a price that is lower than the highest available price bid.”\(^77\) This practice is termed “violating bids and offers,” and the CFTC required no intentional behavior to constitute a violation.\(^78\) It remains unclear, however, what impact the new CFTC guidance will have on HFT practices.

### Other Issues

#### CFTC Reauthorization

Many agencies, including the CFTC, that are funded through the annual appropriations process (referred to as discretionary spending) often follow a two-step process. First, an authorization measure is enacted that may create or continue an agency, program, or activity as well as authorize the subsequent enactment of appropriations.\(^79\) Second, Congress enacts appropriations to provide funds for the authorized agency, program, or activity. In the case of the CFTC and the Commodity Exchange Act, one provision, which authorizes appropriations, expires on September 30, 2013:

> Authorization of appropriations. There are authorized to be appropriated such sums as are necessary to carry out this chapter [1] for each of the fiscal years 2008 through 2013.\(^80\)

Jurisdiction over the annual appropriations process is controlled by the Appropriations Committees in the House and the Senate, and their specialized subcommittees. But responsibility for authorizing bills falls under the jurisdiction of the regular standing committees with oversight over each agency. In the case of the CFTC, reauthorization is under the control of the House and Senate agriculture committees.

In practice, prior extensions of the expiring CEA authorization provisions have often been used as vehicles to effectuate change to other aspects of the CEA. This process has typically been completed after the authorization provision had expired. The most recent CFTC Reauthorization Act was approved in 2008, as part of the Food, Conservation and Energy Act (P.L. 110-246). It authorized appropriations for the next five years ending on September 30, 2013. Between fiscal

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\(^{76}\) Commodity Futures Trading Commission, “Antidisruptive Practices Authority,” 78 Federal Register 31890, May 28, 2013, at p. 31896. The CFTC distinguished the need for the spoofing to be intentional, i.e., “requiring a market participant to act with some degree of intent, or scienter, beyond recklessness to engage in the “spoofing” trading practices ... ;” from behavior that was reckless, negligent, or accidental, which would not constitute a violation.

\(^{77}\) Ibid., p. 31893.

\(^{78}\) Ibid., p. 31893. Under the Commodity Exchange Act §4(c)(a)(5)(A), as amended by §747 of the Dodd-Frank Act, a new section was added to the CEA making it unlawful for any person to engage in any trading practice that violates bids or offers.

\(^{79}\) For more details on this process, see CRS Report RS20371, Overview of the Authorization-Appropriations Process, by Bill Heniff Jr.

\(^{80}\) 7 U.S.C. §16(d).
2006 and fiscal 2008, the CFTC relied on unauthorized appropriations. Its prior authorization had expired in 2005 and was not renewed until 2008.

Earlier reauthorization laws were passed in 2000, 1995, 1992, 1986, 1983, and 1978; and many were used to enact changes to commodities laws. The 2000 reauthorization process culminated in the enactment of broader reforms to derivatives regulation through passage of the Commodity Futures Modernization Act (CFMA), which gave legal certainty to the unregulated nature of swaps. In 2013, the House and Senate agriculture committees have already begun holding CFTC reauthorization hearings. For instance, on May 21, 2013, the House Committee on Agriculture held a hearing on “The Future of the CFTC: Market Perspectives.”

Cost-Benefit Analysis

Some in Congress have sought to increase the requirements for cost-benefit analysis conducted in the CFTC’s rulemakings. Proponents of such measures argue that they would improve the quality of CFTC rulemakings by forcing the agency to more thoroughly weigh costs and benefits. The House Agriculture Committee, which has oversight over the CFTC in the House, on March 20, 2013, marked up and ordered to be reported a bill, H.R. 1003, which would amend the Commodity Exchange Act to mandate that, before promulgating a rule or order, the CFTC must assess both qualitative and quantitative costs and benefits. Further, the CFTC could only adopt a regulation if it made a reasonable finding that the benefits of the intended rule or order justified its costs. The bill also provides a list of 11 items that the CFTC must evaluate in making its determination of costs and benefits.

Critics of the bill argue that the CFTC is already required to conduct cost-benefit analyses in its rulemaking, under Section 15(a) of the Commodity Exchange Act. They argue that many of the targeted potential benefits in certain financial sector rulemakings, such as safer financial markets or reduced risk of financial instability, tend to be intangible and hard to quantify, while the costs are much easier to assess. This can cause costs to be overestimated in general, they argue.

Critics also expressed concerns that such measures could make it easier for industry groups to challenge CFTC rules in court, or for a court to overturn the CFTC’s decision in a case where it found 1 of the 11 enumerated cost-benefit factors to be inadequately performed.

81 P.L. 106-554.
82 7 U.S.C. §§1 et seq. §15(a) states: "Before promulgating a regulation under this chapter ... the Commission shall consider the costs and benefits of the action of the Commission. The costs and benefits of the proposed Commission action shall be evaluated in light of - (A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations." For more on cost-benefit analysis in government please see CRS Report R42821, Independent Regulatory Agencies, Cost-Benefit Analysis, and Presidential Review of Regulations, by Maeve P. Carey and Michelle D. Christensen.
84 Ibid.
Appendix. Background on Derivatives Markets

Derivative contracts are an array of financial instruments with one feature in common: their value is linked to changes in some underlying variable, such as the price of a physical commodity, a stock index, or an interest rate. Derivatives contracts—futures contracts, options, and swaps—gain or lose value as the underlying rates or prices change, even though the holder may not actually own the underlying asset.

Thousands of firms use derivatives to manage risk. For example, a firm can protect itself against increases in the price of a commodity that it uses in production by entering into a derivative contract that will gain value if the price of the commodity rises. A notable instance of this type of hedging strategy was Southwest Airlines’ derivatives position that allowed it to buy jet fuel at a low fixed price in 2008 when energy prices reached record highs. When used to hedge risk, derivatives can protect businesses (and sometimes their customers as well) from unfavorable price shocks.

Others use derivatives to seek profits by betting on which way prices will move. Such speculators provide liquidity to the market—they assume the risks that hedgers wish to avoid. The combined trading activity of hedgers and speculators provides another public benefit: price discovery. By incorporating all known information and expectations about future prices, derivatives markets generate prices that often serve as a reference point for transactions in the underlying markets.

Although derivatives trading had its origins in agriculture, today most derivatives are linked to financial variables, such as interest rates, foreign exchange, stock prices and indices, and the creditworthiness of issuers of bonds. The market is measured in the hundreds of trillions of dollars, and billions of contracts are traded annually.

Derivatives have also played a part in the development of complex financial instruments, such as bonds backed by pools of other assets. They can be used to create “synthetic” securities—contracts structured to replicate the returns on individual securities or portfolios of stocks, bonds, or other derivatives. Although the basic concepts of derivative finance are neither new nor particularly difficult, much of the most sophisticated financial engineering of the past few decades has involved the construction of increasingly complex mathematical models of how markets move and how different financial variables interact. Derivatives trading is often a primary path through which such research reaches the marketplace.

Since 2000, growth in derivatives markets has been explosive. Between 2000 and the end of 2008, the volume of derivatives contracts traded on exchanges, such as futures exchanges, and the notional value of total contracts traded in the over-the-counter (OTC) market grew by 475% and 522%, respectively. By contrast, during nearly unprecedented credit and housing booms, the

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86 For a description of the mechanics of these contracts, see CRS Report R40646, Derivatives Regulation and Legislation Through the 111th Congress, by Rena S. Miller.


The respective value of corporate bonds and home mortgages outstanding grew by 95% and 115% over the same period.\(^9\) From the end of 2008 to the first half of 2011, the total notional value\(^90\) of OTC derivatives contracts grew from $548 trillion to $707 trillion, before falling off slightly to end 2012 at $649 trillion.\(^91\) The estimated credit risk from these OTC derivatives trades—which is the cost of replacing the derivatives contracts at current market prices, referred to as the “gross market value”—was much smaller, however, and was estimated at $24.7 trillion as of the end of 2012, down from $32 trillion at the end of 2008.\(^92\)

**Market Structure and Regulation**

Although the various types of derivatives are used for the same purposes—avoiding business risk, or hedging, and taking on risk in search of speculative profits—the instruments are traded on different types of markets. Futures contracts are traded on exchanges regulated by the Commodity Futures Trading Commission (CFTC); stock options on exchanges under the Securities and Exchange Commission (SEC); and swaps (and some options) have been traded over the counter (OTC), and until passage of the Dodd-Frank Act, had not been regulated by anyone.

Exchanges are centralized markets where all the buying interest comes together. Traders who want to buy, or take a long position, interact with those who want to sell, or go short, and deals are made and prices reported throughout the day. In the OTC market, contracts are made bilaterally, typically between a dealer and an end user, and there had generally been no requirement prior to the Dodd-Frank Act that the price, the terms, or even the existence of the contract be disclosed to a regulator or to the public.

Derivatives can be volatile contracts, and the normal expectation is that there will be big gains and big losses among traders. As a result, there is a problem of market design. How do the longs know that the shorts will be able to meet their obligations, and vice versa? A market where billions of contracts change hands is impossible if all traders must investigate the creditworthiness of the other trader, or counterparty. The way this credit risk—often called counterparty risk—is managed was a key element of the Dodd-Frank reforms.

The exchanges deal with the issue of credit risk through a clearinghouse. Once the trade is made on the exchange floor (or electronic network), it goes to the clearinghouse,\(^93\) which guarantees payment to both parties. The process is shown in Figure 1. Traders then do not have to worry about counterparty default; the clearinghouse stands behind all trades. How does the clearinghouse ensure that it can meet its obligations?

Clearing depends on a system of margin, or collateral. Before the trade, both the long and short traders have to deposit an initial margin payment with the clearinghouse to cover potential losses. Then at the end of each trading day, all contracts are repriced, or “marked to market,” and all those who have lost money (because prices moved against them) must post additional margin (called variation or maintenance margin) to cover those losses before the next trading session. This is known as a margin call: traders must make good on their losses immediately, or their

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\(^90\) The term *notional value*, also called the notional amount, on a financial instrument is the nominal or face amount that is used to calculate payments made on that instrument. The notional amount generally does not change hands.


\(^92\) Bank for International Settlements (BIS), Statistical Annex, Table 19, at

\(^93\) Also referred to as a central counterparty or as (in the statutory phrase) a derivatives clearing organization (DCO).
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broker may close out their positions when trading opens the next day. The effect of the margin system is to prevent anyone from building up a paper loss large enough to damage the clearinghouse in case of default: it is certainly possible to lose large amounts of money trading on the futures exchanges, but only on a “pay as you go” basis.

**Figure 1. Derivatives Market Structures: Exchange and Over-the-Counter (OTC)**

![Figure 1. Derivatives Market Structures: Exchange and Over-the-Counter (OTC)](image)

*Source: CRS.*

In the OTC market, as it evolved with swap dealers as hubs, as shown in the right side of **Figure 1**, there is a network of dealers rather than a centralized marketplace. Firms that act as dealers stand ready to take either long or short positions, and make money on spreads and fees. The dealer absorbs the credit risk of customer default, while the customer faces the risk of dealer default. In this kind of market, one would expect the dealers to be the most solid and creditworthy financial institutions, and in fact the OTC market that emerged is dominated by two or three dozen firms—very large institutions like JP Morgan Chase, Goldman Sachs, Citigroup, and their foreign counterparts. Before 2007, such firms were generally viewed as too well diversified or too well managed to fail; since 2008, they are more likely considered too big to be allowed to fail.

In the OTC market, some contracts require collateral or margin, but not all. There is no standard practice: contract terms are negotiable. A trade group, the International Swaps and Derivatives Association (ISDA) publishes best practice standards for use of collateral, but compliance is voluntary.

The terms collateral and margin are similar—both are forms of a downpayment against potential losses to guard against a counterparty’s nonpayment—but technically they are not interchangeable. A margining agreement requires that cash or very liquid securities be deposited immediately with the counterparty. After this initial deposit, margin accounts are marked-to-market, usually daily. In the event of default, the counterparty holding the margin can liquidate
the margin account. By contrast, collateral arrangements usually require the counterparty to perfect a lien against the collateral. The range of assets allowable under a collateral agreement is usually wider than what is allowed under margining arrangements. Settlement of collateral shortfalls tends to be less frequent than under margining arrangements.

Because there is no universal, mandatory system of margin, large uncollateralized losses could and did build up in the OTC market. The best-known example in the crisis was AIG, which wrote about $1.8 trillion worth of credit default swaps guaranteeing payment if certain mortgage-backed securities defaulted or experienced other “credit events.” Many of AIG’s contracts did require it to post collateral as the credit quality of the underlying securities (or AIG’s own credit rating) deteriorated, but AIG did not post initial margin, as this was deemed unnecessary because of the firm’s triple-A rating. As the subprime crisis worsened, and AIG’s credit rating was downgraded, it was subjected to calls for additional collateral that it could not meet. To avert bankruptcy, with the risk of global financial chaos, the Federal Reserve and the Treasury put tens of billions of dollars into AIG, some of which went to its derivatives counterparties.

### Derivatives Reform

The AIG case illustrates two aspects of OTC markets that were central to derivatives reforms. First, as noted above, AIG was able to amass an OTC derivatives position so large that it threatened to destabilize the entire financial system when the firm suffered unexpected losses, and the risks of default to AIG derivatives counterparties grew. In a market with mandatory clearing and margin, in which AIG would have been required to post initial margin to cover potential losses, there may have been a stronger possibility that AIG would have run out of money long before the size of its position reached $1.8 trillion.

Second, because OTC contracts had not been reported to regulators prior to Dodd-Frank, the Fed and the Treasury lacked information about which institutions were exposed to AIG, and the size of those exposures. Uncertainty among market participants about the size and distribution of potential derivatives losses flowing from the failure of a major dealer was a factor that exacerbated the “freezing” of credit markets during the peaks of the crisis, and made banks unwilling to lend to each other.

A basic theme in the derivatives reform proposals in the runup to Dodd-Frank was to get the OTC market to act more like the exchange market—in particular, to have bilateral OTC swaps cleared by a third-party clearing organization and traded on an exchange or a swap execution facility. Proponents cited widely recognized benefits to clearing and exchange-trading:

- **Reduction of counterparty risk**—collateral or margin collected by the clearinghouse prevents risk build-ups that could trigger systemic disruptions, and

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94 To perfect a lien means following certain procedures required by law in order to create a security interest that is enforceable.


96 Ibid.

97 For additional background on AIG, see CRS Report R40438, *Federal Government Assistance for American International Group (AIG)*, by Baird Webel

98 The credit events that trigger credit swap payments may include ratings downgrades, debt restructuring, late payment of interest or principal, as well as default.

99 For an account of this process, see Office of the Special Inspector General for the Troubled Asset Relief Program (“SIGTARP”), *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, November 17, 2009.
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- **Transparency**—because information on trades and positions is centralized in the clearinghouse, regulators will know who owes what to whom, improving the ability to respond to a crisis. In addition, as price information becomes public, through the exchange or swap execution facility, dealer spreads should narrow, reducing the costs of hedging and other transactions.

At the same time, there are costs associated with a clearing regime that requires all participants to post margin. Firms that use derivatives to hedge business risks take positions that move in the opposite direction to the underlying market. In the example of Southwest Airlines, imagine that energy prices had dropped sharply, instead of rising as they actually did. The reduced fuel costs would have been good for the airline’s bottom line, but its derivatives position would have lost money, and had the contracts been cleared, it would have had to post margin to cover those losses. Such losses would not threaten the firm’s solvency, because it would still be effectively paying a price for fuel that allowed it to operate at a profit. However, the margin demands could have created liquidity problems. Commercial firms, known as “end users” of OTC derivatives argued that the costs of posting margin might prevent them from hedging, leaving them exposed to greater business risks. To meet this concern, the Dodd-Frank Act’s Title VII on derivatives reform included a broad exemption from this clearing requirement for derivatives when one party to the trade is a non-financial firm.

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100 In other words, a hedging strategy locks in the price that prevails at the time the contract is made. If the firm loses money at that price, it will not hedge.