



SPEECHES & TESTIMONY

**Keynote Address of CFTC Commissioner J. Christopher Giancarlo before the American Cotton Shippers Association Annual Conference**

**“American End-Users Should Not Be Collateral Damage”**

**May 26, 2016**

Good morning, ladies and gentlemen. Thank you for your warm welcome. Before I begin, let me say that my remarks reflect my own views and do not necessarily constitute the views of the Commodity Futures Trading Commission (CFTC or Commission), my fellow CFTC commissioners or the CFTC staff.

I am glad to be speaking to you today in Texas outside of the Washington beltway. Before addressing a few of the ever-complicated rules that the CFTC is contemplating, I want to share a personal anecdote. When I was a corporate lawyer, I always tried to spend a day or so with new clients at their offices learning their businesses. I believe you can't truly help someone you represent unless you dig in to understand how they make a living. As a newly minted Commissioner, I made a commitment to continue that practice and learn the businesses of the agricultural, energy and other communities that are served by the CFTC.

In the past two years, I have had the good fortune of travelling to Indiana, Kentucky, Illinois, Iowa and Minnesota – and three times to Texas – to meet with cattle, pork, poultry, corn, soybean, dairy and various other Ag and energy producers. I have also met with a number of cooperatives, manufacturers and futures commission merchants (FCMs) who serve American producers.

One of the starkest realizations I have had is that many of the everyday working people I met on farms and in factories don't know and don't care what Washington does, as long as politicians and bureaucrats don't get in the way of their ability to earn a living. However, these Americans are concerned that increasing ill-conceived regulatory burdens are adding needless costs to their operations, which harm the producer community. They are also concerned about the steep drop in commodity prices, and cotton producers, shippers and merchants are no exception to this rule. As you know, these declines are having an immediate impact on producers' bottom lines and personal checkbooks. These declines are real and are eating away at their livelihoods.

No one can argue that these are good times for America's agricultural producers. Last year, the U.S. Department of Agriculture issued a report further dampening its already-bleak projections for the American farming sector, stating that net farm income would plummet 36 percent from the previous year, reaching its lowest level in nine years.<sup>1</sup> Farmers have not faced such a pronounced freefall since 1983.<sup>2</sup> Unfortunately, farm income is expected to slide even further this year.<sup>3</sup> This is deeply concerning.

This income freefall is directly tied to the severe decline in the price of physical commodities that we have all witnessed since 2010. According to data provided to me this week by the CFTC Office of the Chief Economist (OCE), the Bloomberg investable commodity index is down 48 percent since December 2010.<sup>4</sup>

Cotton is no exception to these declines in commodity prices, as CFTC OCE data shows that the price of cotton has declined 57 percent over the same timeframe. Cotton faces unique pressures that don't apply to other soft commodities at every step of the supply chain, from utilizing specific warehousing and processing facilities to producers having few suitable alternative crops given growing conditions in some parts of the U.S. Further, as all of you are all too aware, the level of world cotton stocks held by certain countries has had a major impact on the market price. Fortunately, that is one international issue that doesn't involve my agency, so I will leave that to the Department of State and others to hopefully sort out.

All the same, what I will discuss today is American markets and how my agency and others in Washington need to fight for the end-users who depend on them. I believe that in order for all segments of our economy to flourish, including the cotton sector, we need thoughtful rules and regulations that encourage participation and innovation in our markets, not the opposite. The CFTC must take care to avoid making end-users collateral damage of new regulations because they are integral to the health of the U.S. economy.

Along those lines, I would be remiss if I didn't mention one rare bright spot of bipartisanship. Last July, the marketplace worked with Congress and the CFTC on a bipartisan and bicameral basis amending the Cotton Futures Act to allow for the creation of a new cotton contract. Such bipartisanship could go a long way in solving many of the issues facing our economy and our markets. At the end of the day, ensuring exchanges, producers and businesses are able to innovate and compete on a global level isn't a Republican or Democrat issue, it's an American issue.

Now, let me discuss a few regulatory issues that impact markets overseen by my agency.

Last spring, the CFTC finalized a "customer protection" rule that amended Commission regulation 1.22 so that the residual interest deadline for FCMs did not automatically adjust to the start of business the next morning after a trade, and instead would remain at the close of business the next day following a trade. In plain English, we prevented a rule from going into effect that would have required producers to pre-fund their margin accounts. In late 2014 when I met with family farmers in Shelby County, Kentucky, they could not fathom why the CFTC would propose a rule requiring them to pre-fund their margin accounts. They saw our rule as insuring that they would actually lose MORE of their money – not less – in the event of a future failure of another MF Global or Peregrine Financial. It didn't make much sense.

Fortunately, the current Commission saw the error of that proposal, and my staff fought hard to ensure that any change to the residual interest deadline can only occur if a new rule is proposed with a vote of the Commission and public comment. Fortunately, a recent CFTC staff report<sup>5</sup> recommended that the deadline be kept the same as well, so I am glad that issue appears to be resolved, for now.

Next, last December, after numerous iterations, several comment periods, significant legislative interest from Congress, and months of negotiating, the Commission finalized a change to one of its recordkeeping rules. While that may sound benign, let me give you some background. In 2012, the Commission revised long-standing Rule 1.35 despite the fact that the Dodd-Frank Act<sup>6</sup> contained no mandate to change the CFTC's recordkeeping rules.<sup>7</sup> The revised rule proved to be unworkable. Its publication was followed by requests for no-action relief and a public roundtable at which entities impacted by the rule voiced their inability to tie all communications leading to the execution of a transaction to a particular transaction or transactions. End-user exchange members pointed out that business that was once conducted by telephone had moved to text messaging, so the carve out in the rule for oral communications had little utility. They pointed out that it was simply not technologically feasible to keep pre-trade text messages in a form and manner "identifiable and searchable by transaction." Further, bipartisan Congressional action on the rule's unworkable nature made it clear that the Commission should re-open the rule to lessen the burden on market participants not registered with the CFTC.<sup>8</sup>

In November 2014, the CFTC did propose changes to Rule 1.35.<sup>9</sup> Unfortunately, I could not support that proposal because it did not go far enough in addressing concerns about the feasibility and cost of compliance.<sup>10</sup> It still contained provisions that were overly burdensome in practice for certain covered entities. For example, the proposal kept 2012 rule revisions that required the keeping of all oral and written records that lead to the execution of a transaction in a commodity interest and related cash or forward transaction in a form and manner "identifiable and searchable by transaction."<sup>11</sup> This "searchable" requirement also conflicted with the requirements of Commission Rule 1.31, which applies to all books and records required to be kept by the Commodity Exchange Act and Commission regulations.

Appropriately, the final revisions to Rule 1.35 address many of the issues that caused me to vote against the 2014 proposal.<sup>12</sup> End-user exchange members that are not registered or required to be registered with the Commission now must only keep transaction records, which is a logical and prudent course of regulatory policy. Text messages are also excluded from the recordkeeping requirement for end-users, but communications through internet-based messaging services, such as i-Messages, must be kept on file. While not perfect, I believe the final Rule 1.35 generally gets the balance right.

Yet, last November, the CFTC proposed a rule called Regulation Automated Trading, also known as "Reg AT."<sup>13</sup> This proposal took almost two years to craft and is, in essence, a registration scheme. However, registration is not policy and policy is not registration. The relatively simple process of registering users of trading algorithms does not begin to address the complicated public policy considerations that arise from the transformation of trading markets from 20<sup>th</sup> century analog to 21<sup>st</sup> century digital.

Unfortunately, for America's cotton industry, if your firms use any type of automation with

respect to futures trading, even if you use a simple automated excel spreadsheet that facilitates trading, you may be captured by Regulation AT. Many unregistered market participants, and I suspect there are a few in this room, would be forced to register for the first time with the CFTC as “floor traders” due to the very broad definition of “algorithmic trading.”<sup>14</sup> As new floor traders, the same market participants that were just provided relief from unnecessary and burdensome recordkeeping requirements under Rule 1.35 would now be perversely recaptured.

If captured, firms newly registered with the CFTC will be forced to tie together all “written communications provided or received concerning quotes, bids, offers, instructions, trading, and prices *that lead to the execution of a transaction*.”<sup>15</sup> I encourage market participants to carefully review and consider the compliance and cost consequences of that potential new regulatory regime and compare it to last year’s common-sense revisions to Rule 1.35. The comment period for the proposal closed in March and I am looking forward to reading how end-users think this rule will impact their risk management practices. There will be another bite at the apple, however, as I expect a CFTC staff roundtable will be held in June to discuss the issue, which will re-open the comment period and allow for further public input.

Finally, I should say a few words about a rulemaking that has been ongoing in Washington for at least 6 years: position limits. I have been a critic of the 2013 proposed rule, which was the CFTC’s second attempt to impose a new federal position limits regime on 28 types of commodities, including cotton. That 2013 proposal was formulated before I or my two fellow CFTC commissioners joined the agency. In the face of plunging commodity prices, I voiced my concerns that the overall effect of the CFTC’s 2013 proposal was to impose federal regulatory edicts in place of everyday business judgements to manage risk.<sup>16</sup>

My criticism of that 2013 proposal does not mean that I will not support an effort to improve the proposal by taking into account the genuine concerns voiced by the agricultural, energy and end-user communities to make the rule workable.

Correcting undue restrictions on bona-fide hedging is vital to American Ag and energy producers and their ability to manage risk. Such corrections will go a long way to alleviating some of my reservations with the rule. We must not forget that cotton has been subject to federal position limits for decades. In the effort to set limits for other commodities, we cannot eliminate tried and true hedging strategies for cotton producers, shippers and merchants.

Further, we must update deliverable supply estimates for the 28 referenced commodities to replace the sometimes decades-old data used in the 2013 proposed rule. In addition, drawing upon the exchanges’ decades of experience running markets and administering position limits may also make a final rule more practicable. At the end of the day, the CFTC’s goal must be to encourage – not discourage – commercial enterprises to utilize advances in hedging practices to help keep America competitive in a global economy. I believe that we will see some common-sense proposals to make the rule more workable in the very near future.

In closing, in my two years at the Commission, I have become acutely aware that regulators must scrupulously avoid needless red tape and compliance costs. That is because such costs are invariably passed along through higher prices for everyday items like a loaf of bread, gallon of gasoline or pair of socks. The common refrain I hear again and again is that Washington does not listen to everyday Americans. It imposes rules and regulations without regard to their obvious impact on ordinary people. At a time when farmers struggle to put food on *their* tables, the CFTC must promote policies that do not needlessly impinge on the ability to hedge against plummeting prices. I am hopeful that the CFTC will listen to the public’s thoughts on the rules I just described to you.

Now and always, we must balance regulatory burdens with clear economic benefits if we are to maintain safe, durable and robust commodity hedging markets that underpin our American way of life.

Remember, American prosperity requires vibrant markets and capital freedom.

Thank you.

<sup>1</sup> U.S. Dep’t of Agric., August 2015 Farm Sector Income Forecast p. 1, 9 (2015).

<sup>2</sup> *Id.* at 2.

<sup>3</sup> U.S. Dep’t of Agric., August 2016 Farm Sector Income Forecast (2016), *available at* <http://www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances/2016-farm-sector-income-forecast.aspx>.

<sup>4</sup> The Bloomberg Commodity Index weighs agricultural futures as 36.1 percent, energy

futures (includes 15 percent crude oil) as 29.7 percent and metals as 34.2 percent of the index.

<sup>5</sup> See U.S. Commodity Futures Trading Comm'n, Residual Interest Deadline for Futures Commission Merchants Report (May 13, 2016), *available at* <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/residualinterestreport>

<sup>6</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

<sup>7</sup> See Adaptation of Regulations to Incorporate Swaps-Records of Transactions, 77 FR 75523 (Dec. 21, 2012), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2012-12-21/pdf/2012-30691.pdf>.

<sup>8</sup> See Customer Protection and End-User Relief Act, H.R. 4413, 113th Cong. § 353 (2014) and Commodity End-User Relief Act, H.R. 2289, 114th Cong. § 308 (2015).

<sup>9</sup> See Records of Commodity Interest and Related Cash or Forward Transactions, 79 FR 68140 (Nov. 14, 2014), *available at* <http://www.cftc.gov/idc/groups/public/@lfederalregister/documents/file/2014-26983a.pdf>.

<sup>10</sup> See *id.* at 68147-148 (Dissenting Statement of Commissioner J. Christopher Giancarlo).

<sup>11</sup> See *id.*

<sup>12</sup> See Records of Commodity Interest and Related Cash or Forward Transactions, 80 FR 80247 (Dec. 24, 2015), *available at* <http://www.cftc.gov/idc/groups/public/@lfederalregister/documents/file/2015-32416a.pdf>.

<sup>13</sup> See Regulation Automated Trading, 80 FR 78823 (Dec. 17, 2015), *available at* <https://www.gpo.gov/fdsys/pkg/FR-2015-12-17/pdf/2015-30533.pdf>.

<sup>14</sup> *Id.*; See definition of “Algorithmic Trading” in proposed Commission regulation 1.3(ssss), which is very broad and would appear to capture market participants using off-the-shelf type automated systems or simple excel spreadsheets to automate trading.

<sup>15</sup> Emphasis added; See Commission Rule 1.35(a)(1)(iii) (defining “written pre-trade communications”) and Rule 1.35(a)(2)(ii) (requiring all “floor traders” to keep all “written pre-trade communications”).

<sup>16</sup> See Keynote Address of Commissioner J. Christopher Giancarlo, 7th Annual Capital Link Global Commodities, Energy & Shipping Forum, Sept. 16, 2015, *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-8>.