Senate Committee on Agriculture, Nutrition & Forestry
Reauthorization of the Commodity Futures Trading Commission
Hearing: July 17, 2013
Question for the Record
Mr. Dennis M. Kelleher
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Chairwoman Debbie Stabenow,

1) At the hearing, you discussed the importance of additional resources for the CFTC and the costs of self-funding the agency. Do you believe that self-funding for the CFTC can be done in a way that doesn't harm market liquidity and gives the agency the resources it needs to do its job? Can you provide a detailed assessment of the cost of funding the agency at current levels through industry assessments or fees?

Summary

The CFTC is now responsible for the regulation and oversight of the vast, complex swaps, futures, and options markets. Given that the last crisis was incubated and spread throughout the globe via these markets, the CFTC is unquestionably among the most important financial regulators and essential to protecting the American people from another financial collapse. Yet, its funding levels are grossly insufficient to do its job and have not increased in proportion to the magnitude of the new duties it has been charged with in the Dodd-Frank Consumer Protection and Wall Street Regulation Act ("Dodd-Frank Act").

While many essential government services have to be funded by the taxpayers, that is not the case for the CFTC. As the analysis below shows, the CFTC's funding needs could be **fully met**, without recourse to taxpayer funds, by imposing a fee of as little as $1 per million dollars of **notional** value on each swap contract, and just 28¢ per million dollars of notional value on each futures and options contract transacted in the United States (for each party to the swap). This would be a 0.0001% transaction fee, a hundredth of a basis point, on swaps, and a fraction of that amount for futures and options.

Such a small CFTC funding fee would not harm market liquidity. For instance, according to DTCC data, the average interest rate swap transaction has a notional size of approximately $58 million.[1] The private execution cost for such a swap is typically around $1,000.[2] Under the proposal here, the incremental CFTC funding fee would be $58.

[1] Calculated from a random sample of days in July and August 2013 using data taken from https://rtdata.dtcc.com/gtr/inquiry.do.

[2] Based on discussions with swap market participants.

Similarly, a farmer with 500 acres of corn crop could hedge his entire yield (approximately 75000 bushels) on the CME with 15 corn futures contracts.[3] The CME execution fees on this order would exceed $10, yet the incremental CFTC funding fee would be just 10¢.[4]

Given its small size, a CFTC funding fee of $1 per $1 million of notional swaps and 28¢ per $1 million of notional futures and options would have no noticeable impact on liquidity and would be highly unlikely to influence any trading decisions. The decision to hedge or not can make a difference of tens if not hundreds of thousands of dollars to an individual farmer or business. It is hard to imagine any such true end users or their customer-facilitating brokers being driven away from the market by a dime fee.

In fact, academic literature supports the notion that *de minimis* financial transaction fees have a negligible or zero impact on liquidity. For instance, recent research from the University of Massachusetts found that developed financial markets tend to tolerate transaction fees of up to 50 basis points with little or no impact on liquidity.[5] The CFTC funding fee proposed here would be a miniscule fraction of that amount.[6]

It is important to remember that the CFTC is the only financial regulator that does not impose fees to fund itself; put another way, the current funding mechanism of the CFTC makes it the only financial regulator that burdens the taxpayer. And, the CFTC funding proposal here would be, by far, the smallest fee among the financial regulators. For example, the SEC currently charges user fees of $17.40 per million dollars of securities to raise over $1 billion annually in revenues.[7] (And, even this sized fee has not impaired liquidity.) Thus, the proposal we are advancing is a small fee which would raise a modest amount of revenue necessary to adequately fund a hugely important regulator, while not harming liquidity.

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[3] Using yield data from USDA to estimate a 150 bushel per acre yield.

[4] The CME pricing schedule is quite complicated with multiple price points depending upon whether the trader is a member or non member, and whether the trade is a brokered trade or a proprietary trade. Nevertheless, it is not hard to see that a typical transaction costs many multiples of what the proposed transaction fee would amount to. For a Eurodollar Contract (and most of the financial contracts) the CME charges the broker 5 cents and the customer 5 – 20 cents depending upon the size of the customer. For an agricultural commodity contract the CME charges the broker 6 cents and the customer between 10 and 90 cents.

[5] Robert Pollin & James Heintz, *Transaction Costs, Trading Elasticities and the Revenue Potential of Financial Transaction Taxes for the United States*, Political Econ. Research Inst., Univ. of Mass., Dec. 2011, *available at* http://www.peri.umass.edu/fileadmin/pdf/research_brief/PERI_FTT_Research_Brief.pdf.

[6] There will, however, no doubt that some who claim – without basis or evidence -- that even a miniscule CFTC funding fee will harm markets. If these unfounded claims were to cause concern, there is no reason that Congress could not phase in this fee, starting, for example, with a fee in the first year of just 50¢ per $1 million of notional value, which would be a 0.00005% transaction fee. This would be sufficient to cover half of the CFTC's current annual budget needs. The second year this fee could go to 75 cents and then to $1 per $1 million of notional in the third year of the phase in. At any one of these 3 levels, this CFTC funding fee would represent a tiny addition to existing user fees levied by all the for-profit exchanges.

[7] SEC Press Release 2013-74, *Fee Rate Advisory #3 for Fiscal Year 2013,* Apr. 25, 2013, http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514024#.UhJdOmTTUxQ.

The CFTC's Responsibilities Have Increased Massively

The role of the CFTC in today's U.S. and global derivatives and commodities markets is far greater than at any point in its history. Until the Dodd-Frank Act was passed in July 2010, the CFTC's jurisdiction was limited to the $40 trillion futures market. The worst financial crash since 1929 and the worst economic crisis since the Great Depression prompted Congress to give the agency the additional responsibility for overseeing the previously unregulated $340 trillion swaps market—a market **over 8 times the size** of the futures market. As is widely known, this was necessary because the global financial crisis of 2008 was largely incubated in and triggered by dark, unregulated derivatives markets. The Dodd-Frank Act therefore amended the Commodity Exchange Act to require the CFTC to regulate those markets and require transparency and prudent risk management so that such a calamity would never happen again to the American people.

As I stated in my testimony, given how historic these changes are, the Committee should consider renaming the CFTC as the "Commodities Futures and Swaps Trading Commission" ("CFSTC") so that its name more accurately reflects the breadth and depth of its jurisdiction and mission. After all, its jurisdiction has increased enormously and has been extended to entirely new markets and products.

The CFTC has done an outstanding job in transforming the Dodd-Frank law into a derivatives market reality (even though we have often not agreed with particular provisions of certain rules). History will look back and laud its singular accomplishments. The CFTC is to be commended for this. However, it has been a struggle and, too often, needlessly so, mostly due to inadequate resources, which have deprived the agency of enough personnel and technology to do the job the law requires of it. Without a greatly increased budget and stable funding source, the CFTC will simply not be able to continue to implement the law, oversee these vital markets, ensure financial reform is a durable reality, and protect the American people from another derivatives-fueled crash.

At the same time, the CFTC provides crucial services to the marketplace, including issuing guidance, processing registrations, disseminating data, and protecting customers and market participants from abusive practices. These are all tasks that must be performed on time and to a high standard if they are to be useful to the market and market participants. Fully funding the CFTC is a small price to pay to ensure it gets its job done in a timely and thorough fashion.

The CFTC is Woefully Underfunded

From 1999 to 2007, the CFTC staff decreased from 567 full-time equivalents ("FTEs") to just 437. Currently, the CFTC has 690 FTEs which is less than 10% more than at the peak in the 1990s.[8] Comparably, the volume of futures trading in the United States from 2000 to 2013 has exploded from 491 million contracts per year to over 7 billion contracts per year, an increase of more than 1300%.[9] At the time of writing, the CFTC has just 162 FTEs in enforcement, (with a pending request for an increase to 213 FTEs for 2014).[10] This low number persists in spite of the fact that the Dodd-Frank reforms triggered by the financial crisis mean that the CFTC now has to police more registrants than ever before: 62,958 as of September 2012.[11] If the new rules and regulations are not properly enforced, financial reform will exist only in form, and not in substance.

Similarly, the Market Oversight division, responsible for monitoring the entire swaps and futures markets in real time, has just 119 FTEs.[12] The CFTC has requested sufficient funding to raise this number to 177 – still a low number, but one that stands a better chance of identifying emerging issues before they escalate. This is essential to the regulatory function, and could save investors and taxpayers large sums of money by preventing problems from arising in the first place rather than simply punishing wrongdoers after the fact.

Yet even with new surveillance personnel, as Commissioner Scott O'Malia has pointed out, the current technological limitations at the agency mean even an event as significant as JP Morgan Chase's so-called "London Whale" debacle[13] would currently go undetected, since "none of our computer programs load [Swap Data Repository] data without crashing."[14] According to Commissioner O'Malia, the current CFTC budget allows for only about $12 million for actual technology investment.[15] To put this in perspective,

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[8] Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission before the U.S. Senate Banking, Housing and Urban Affairs Committee, Washington, DC (Feb. 14, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-131.

[9] Will Acworth, *Volume Climbs 11.4 percent to 25 Billion Contracts Worldwide*, FUTURES INDUSTRY, Mar. 2012, *available at* http://www.futuresindustry.org/files/css/magazineArticles/article-1383.pdf.

[10] CFTC PRESIDENT'S BUDGET AND PERFORMANCE PLAN, FISCAL YEAR 2014, PREPARED FOR THE COMMITTEE ON APPROPRIATIONS, at 8 (Apr. 2013) *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2014.pdf.

[11] *Id.* at 97.

[12] http://www.cftc.gov/reports/presbudget/2014/2014presidentsbudget020102.html.

[13] U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, JPMORGAN CHASE WHALE TRADES: A CASE HISTORY OF DERIVATIVES RISKS AND ABUSES (Mar. 15, 2013) ("PSI Report"), *available at* http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-2013.

[14] Silla Brush, *Dodd-Frank Swap Data Fails to Catch JPMorgan Whale, O'Malia Says,* BLOOMBERG, Mar. 19, 2013, *available at* http://www.bloomberg.com/news/2013-03-19/dodd-frank-swap-data-fails-to-catch-jpmorgan-whale-o-malia-says.html.

[15] Testimony of CFTC Commissioner Scott D. O'Malia Before the U.S. House Committee on Appropriations, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies,

that is about as much as what just a dozen or so large high frequency traders might pay for a year's worth of colocation fees alone—to say nothing of the rest of their technology budget and that of the other entities regulated by the CFTC.[16].[17]

Sending the CFTC out to regulate and police these markets without adequate funding is setting them up to fail. Markets are adapting to the new rules of the road, and the regulators must be equipped with the technology and staff that they need to keep up.

And, again, we are talking about a modest amount of money. By way of comparison, the CFTC's entire budget for 2012, totaling $206 million, was less than half the $574 million paid in compensation in 2007 to the top executives at the nine banks who received the first round of TARP funds.[18] The President's pending budget request of $315 million for FY2014 is barely one fifth of the sum that "disappeared" during the MF Global fiasco, and only slightly more than what was misappropriated from customers in the fraudulent Peregrine Financial scheme that was discovered last year.[19] In light of the importance of its vastly expanded responsibilities, the CFTC's funding requests are reasonable, necessary, urgent, and for the benefit of the markets and all market participants.

User Fees are Assessed by Virtually All Federal Financial Agencies

A logical way to approach CFTC funding is through a deficit-neutral user fee model. User fees are revenues collected by a governmental agency for goods and services provided to the public. Since they are used to pay for the cost of providing those goods and services, they are considered "offsetting receipts" for accounting purposes. Thus, user fees ensure the public receives the protections necessary for the efficient functioning of markets, while also ensuring that those market participants who receive the greatest benefit from well-functioning markets pay a fair share of their costs. An added benefit of the deficit-neutral user fee model is that congressional appropriators maintain control over the level of agency funding – it is only the means of funding that is modified.

The federal government has historically employed user fees as a source of revenue for many years. In fiscal year 2012 alone, OMB reports about $8.6 billion dollars in user

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Washington, DC (Apr. 12, 2013), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-23.

[16] Assuming three servers at the CME colocation facility (DC3), an HFT would pay approximately $11,000 per month in hosting, connectivity, and access fees (according to the CME price list). That works out to $132,000 per year just for one exchange, and most HFTs operate across a number of exchanges. For the largest such traders, therefore, an estimate of $1 million per year in colocation fees is not unreasonable.

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[18] *Big bank execs: What they take home*, CNN MONEY, http://money.cnn.com/news/specials/storysupplement/ceopay/.

[19] http://money.cnn.com/2012/04/24/news/companies/mf-global/index.htm and http://www.cftc.gov/PressRoom/PressReleases/pr6300-12

fees were collected by federal agencies. These fees are included in the Federal Budget, and congressional appropriators set the amounts that can be collected and utilized to offset the costs of the goods and services. For budgetary purposes the revenue and expenditure offset, so there is no real use of taxpayer monies. But the amounts collected and spent are recorded in Federal Budget documents.

With the exception of the CFTC, virtually every federal financial agency raises revenue through some sort of fee. For example, the OCC assesses a semi-annual fee on national banks and federal savings associations. The assessment is based on a financial institution's total assets and other information as reported in the call and thrift financial reports. The funds are used primarily to cover the cost of examinations. The FDIC and the Federal Reserve Board also have access to user fees, as does the SEC.

The federal financial regulator most closely mission-related to the CFTC is the SEC. The amount of money the SEC can collect to offset expenditures is set by the Congress each year for the next fiscal year. The SEC then charges securities transaction fees it will collect to equal the amount set by the appropriators.

In addition, the SEC is authorized to maintain a Reserve Fund of up to $100 million to pay for SEC expenses. This fund is not subject to congressional appropriations and is funded from filing fees the SEC collects. The agency can deposit up to $50 million per fiscal year but the funds in the Reserve Fund cannot exceed $100 million. Any excess filing fees are deposited in the Treasury General Fund and cannot be used to fund SEC operations.

And it is not just financial regulators who are authorized to assess user fees. For example, in a House-passed appropriation bill for FY 2014, the Federal Communication Commission ("FCC") is authorized and has been appropriated $320 million to fund the Commission's activities. The law also provides the FCC with the authority to assess and collect funds pursuant to Section 9 of Title 1 of the Communications Act of 1934, resulting in a final fiscal year appropriation of $0. Specific restrictions say that the agency can only spend $320 million. If excess fees are collected, they are sent the Treasury general fund and cannot be carried over to the next fiscal year.

Some agencies are authorized to offset only a portion of the revenue and expenditures. For example, fees to enter national parks can be used to offset the costs of maintaining the parks but are not intended to cover the entire amount of the activity. Another example is in a House-passed appropriation bill for fiscal year 2014, the Federal Trade Commission has $295 million appropriated for the agency. Of this amount, they may collect up to $103.3 million in fees for the premerger notification filing required by the Hart-Scott-Rodino Antitrust Improvement Act of 1976.

Thus, there is ample, long-standing precedent and ongoing practice for the CFTC to be funded, in whole or in part, by a small fee.

The Fees Required to Fund the CFTC Would Be Minimal and Would Not Harm Liquidity

DTCC data indicates roughly $72 trillion notional in annual swaps trading under the CFTC's jurisdiction.[20] Dividing this by the CFTC's $315 million budget request for 2014 and then dividing it by two (to account for the two counterparties to each trade) would only require a $2.19 fee per $1 million of notional value of swaps or just 0.0002%.

This CFTC funding fee in the swaps markets could be reduced if such a fee were also imposed on transactions in the futures market. The futures market, though smaller in outstanding notional size than the swaps market, turns over much more quickly. BIS data indicates that total notional trading in futures and options may therefore outnumber swaps by multiples.[21] Nevertheless, opponents of a user fee on futures rightly point out that futures were not implicated in the financial crisis, unlike swaps. Therefore, despite the fact that notional trading of futures exceeds that of swaps, we assume here a 50-50 split for the fee base between futures and swaps. This would reduce the $2.19 per $1 million of notional value figure to $1.08 per $1 million of notional value for swaps, which we round down to $1. At this level, the fee would add just $58 to the $1,000 cost of a typical interest rate swap transaction.

For futures, BIS data indicates that approximately $814 trillion of exchange traded options and futures change hands annually in North America. Even assuming a quarter of this occurs outside of the United States or otherwise outside of the CFTC's jurisdiction, that still leaves a $600 trillion fee base. This would require just 28¢ per million dollars of notional futures and options to generate the 50% funding share attributed to futures. At this level, just 10¢ would be added to the $10 transaction cost associated with hedging 500 acres worth of corn, a truly *de minimis* amount.[22]

The fees could be even smaller than this minimal level. For example, funding just 50% of the CFTC's budget with fees would require just 50¢ per $1 million of notional value traded on swaps, and 14¢ per $1 million of notional value traded on futures and options. This would amount to a $29 fee on a typical interest rate swap, and just 5¢ on a *bona fide* hedge of a farmer's entire corn crop.

Given its small size, such a fee would therefore have no noticeable impact on liquidity. Decisions to hedge or not are based on calculations of tens of thousands of dollars at the very least and more often hundreds of thousands if not millions. It is inconceivable that a fee ranging from a few cents to a few dollars would have any influence whatever on the economics of these decisions.

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[20] This total was calculated by averaging the total notional amount traded on a random sample of days in July and August 2013 (the only robust data currently available) and then multiplying by 252 annual trading days to obtain an estimate of total annual notional value traded. Raw data taken from https://rtdata.dtcc.com/gtr/inquiry.do.

[21] BIS, Table 23A: Derivative financial instruments traded on organised exchanges, http://www.bis.org/statistics/r_qa1306_hanx23a.pdf.

[22] *See* notes 1-4, *supra.*

Importantly, academic literature supports this observation. For example, recent research from the University of Massachusetts found that developed financial markets tend to tolerate transaction fees of up to 50 basis points with little or no impact on liquidity.[23] The proposed CFTC user fee would be just a hundredth of a basis point. Thus, the available evidence supports common sense and reasonable business decisions in suggesting that there would be no impact on liquidity from such a fee.

Conclusion

The CFTC can be fully self-funded by a *de minimis* user fee on swaps, and an even smaller user fee on futures and options. We hope you find this analysis useful as you continue to frame policy in this arena.

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[23] Robert Pollin & James Heintz, *Transaction Costs, Trading Elasticities and the Revenue Potential of Financial Transaction Taxes for the United States*, Political Econ. Research Inst., Univ. of Mass., Dec. 2011, *available at* http://www.peri.umass.edu/fileadmin/pdf/research_brief/PERI_FTT_Research_Brief.pdf.