TESTIMONY OF SCOTT D. O'MALIA
COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
U.S. HOUSE COMMITTEE ON APPROPRIATIONS,
SUBCOMMITTEE ON AGRICULTURE, RURAL DEVELOPMENT, FOOD AND DRUG ADMINISTRATION, AND RELATED AGENCIES

WASHINGTON, DC
APRIL 12, 2013

Good morning Chairman Aderholt, Ranking Member Farr and members of the Subcommittee. Thank you for the opportunity to testify on the Fiscal Year (FY) 2014 budget request for the Commodity Futures Trading Commission (Commission). I am honored to testify alongside Chairman Gary Gensler and provide my perspective on the Commission's funding request and budget priorities.

For FY 2014, the Commission is seeking a 52.5 percent increase above the current year funding level of $206.5 million. The Commission sought similarly large increases in past requests. Although the Congress has not provided full funding, additional funding resources have been provided to support our expanding mission.

In FY 2007, prior to the 2008 financial crisis, the Commission received $97.7 million and supported 437 full-time equivalent (FTE) staff and 59 FTE contractors. Today, after consistent funding increases, the Commission is operating on $206.5 million (+111%) and supports 707 FTE staff (+62%) and a further 200 FTE contractors (+239%). Funding for technology has also grown during this time, and I appreciate Congress setting aside specific funding levels since FY 2011 to encourage the Commission to focus on technology as a key component of its surveillance and oversight program, but we have a very long way to go to develop a credible, detailed business plan that focuses on how both staff and technology resources are integrated to meet mission objectives.

Budget Requests Should Specify Priorities

I did not vote for the Commission's FY 2014 budget request for two reasons. First, I believe the requested funding level of $315 million, an increase of 52.5 percent from current year funding, is both improbable and unsustainable. Second, this budget fails to provide specifics and makes a broad, unsubstantiated appeal for more resources without the requisite demonstration of either mission priorities or essential deliverables. This shortcoming is especially glaring in the area of how regulatory objectives are met through the integrated use of staff and technology, as I discuss in detail below. The budget request presents everything as a priority and provides no metrics by which to measure the Commission's success or failure.

As the former Clerk of the Senate Energy and Water Subcommittee, I know first-hand the challenges you face to allocate scarce resources among agencies and commissions seeking funding increases to support their missions. These are not easy choices, and they are made even more difficult with today's acute deficit pressure.

Now, in my position as a regulator, I am working to make sure that the Commission is a responsible and effective steward of taxpayer resources. For you to have confidence in our mission, we must develop a credible, transparent and specific budget request that we are able to execute in fulfilling our statutory mission. We must demonstrate the importance of our mission, our specific plan to achieve our mission, and the likelihood of our success.

I do believe there is a strong case to be made for the importance of our mission. Expanding our mission to oversee the swaps markets, along with existing oversight of the futures and options markets, is significant and can provide improved risk management and oversight of our financial system. It is also apparent that this expanded mission cannot be accomplished without modest increases in resources for the Commission. What is questionable, however, is whether the Commission has developed a sufficiently clear plan to achieve this mission, and a sufficiently detailed budget request to reflect such a plan.

Leveraging Technology to Keep Pace with the Markets and Commission Rules

Since I arrived at the Commission, each budget request that I have reviewed, including this one, includes a chart highlighting the stratospheric rise in futures trading as a justification for a sizable increase in our budget. It is important to understand when reviewing this chart that the rise in futures trading is strongly tied to the increasing prevalence of electronic trading and the deployment of algorithmic and high-frequency trading protocols. Execution in today's market is done electronically. Therefore, if the Commission is going to keep pace with growth and technological innovation in these markets, it must make automated surveillance the foundation of its oversight and compliance program.

Presently, high-frequency traders (HFT) are estimated to make up 52 percent of the global futures markets and 56 percent of U.S. equities markets.[1] As we learned in the flash crash of May 6, 2010, these markets are linked and we need to develop better oversight tools. We also need to develop a better understanding of trading strategies used by algorithmic traders, and that is not gained by solely using stale transaction data; we also need to integrate order message data into our surveillance program. Unfortunately, the Commission is not funding its order messaging collection effort, despite the fact that we know little about the trading behavior of high-frequency trading algorithms.

In addition to overseeing a high-speed electronic marketplace, the Commission has expanded the amount of data being reported to the Commission, not to mention expanding the oversight of many new trading venues. With all the new forms and data that the Commission has required, it will be like looking for a needle in a haystack if we fail to automate the collection and analysis of this data. We must prioritize our regulatory objectives in this area, and develop a business strategy that maximizes technology to meet those objectives.

Automation should also be the priority for existing forms and data. We have made progress on this front, but more needs to be done. One of the current forms that is not automated drives our widely read Commitment of Traders Report. This remains a labor intensive endeavor that should be fully automated sooner rather than later.

[1] Financial Stability Oversight Council 2012 Annual Report, pg. 88 (citing study by Aite Group).

Solving Our Big Data Challenges

Today, tens of millions of trades are being reported per week to swap data repositories (SDRs). While we have a long way to go before we can make sense of this new data, we must rely on the SDRs to manage the data for the Commission because it is outside the Commission's capacity to integrate the data into our own systems.

One of the foundational policy reforms of Dodd-Frank is the reporting of over-the-counter trades to SDRs. The goal of data reporting is to provide the Commission with the ability to look into the market and identify large swap positions that could have a destabilizing effect on our markets. While the rules have been finalized and swap dealers have been submitting data since January of this year, the work to make effective use of SDRs is just beginning.

The harmonization of data from dealers and end users into SDRs must be a top priority of the Commission and industry so that Dodd-Frank objectives can be realized. Furthermore, the technology capabilities and reporting done by SDRs must be standardized to provide regulators a view across repositories that facilitate data aggregation and oversight.

As head of the Commission's Technology Advisory Committee (TAC), I will make it a TAC priority to help resolve the outstanding challenges and to achieve these goals. The TAC's next meeting is on April 30, when we will hear from market participants, SDRs, and Commission staff on current challenges and discuss steps to address them. Beyond this meeting, I will continue to commit the TAC's focus and energy toward the Commission's efforts to make effective use of SDR data.

Correcting our shortcomings in utilizing our data demands sustained and focused attention on this matter. First, it requires a team of staff that can work to better organize the data to ensure it is being reported consistently and completely. Next, the data must be in a form and format that can be easily used by the Commission. Finally, the team should focus on developing analytical reports that can serve our highest priorities in terms of market oversight and risk analysis. In FY

2013, Congress provided more funds than have ever been previously applied to technology – these funds can be used to attack our data problems.

The Commission will not succeed in its mission unless it makes technology its top priority and works to integrate it into every aspect of its oversight mission. Technology provides leverage for our workforce to oversee multiple exchanges, clearing houses and intermediaries.

Protecting Customer Segregation Funds – There Is an App for That

I believe the Commission has only scratched the surface of the technology applications we can develop and deploy. This belief has been confirmed by a new industry initiative deployed this year to monitor and protect customer funds. In response to the Peregrine Financial fraud and the misuse of funds by MF Global, the National Futures Association (NFA) and the CME Group, two self-regulatory organizations (SROs), were able to implement a customer segregation surveillance system to reconcile, on a daily basis, the balances claimed by the futures commission merchant (FCM) and the custodian bank. Today, FCMs and banks automatically push out daily balances that are reconciled by an independent third party alerting the SROs to the slightest deviations in the expected balances of both cash and securities.

This technology solution was 100 percent paid for by the industry and developed without a federal rule. It highlights the great potential of technology to help us perform our oversight responsibilities in an efficient manner given our limited resources.

Contrast this with the solution offered by the Commission as part of its proposed customer protection rules.[2] The proposed rule calls on Commission staff to manually log on to the thousands of custodian accounts using an account password. This is totally unworkable from a staffing and resource standpoint, not to mention the cyber security concerns it raises. In developing our rules, we must consider and plan how we will conduct our oversight activities and just like our cost-benefit analysis, we must consider the feasibility of our proposals given the resources available.

[2] 77 FR 67866 (November 14, 2012).

What Is the Actual "Technology" Investment?

Beginning in FY 2011, the Congress has set minimum thresholds for the Commission to spend on "technology." The FY 2011 appropriation provided that "not less than $37,200,000 shall be for the highest priority information technology activities at the Commission."[3] The FY 2012 appropriation provided that "$55,000,000 shall remain available for information technology investments until September 30, 2014."[4] Just one month later, the $55 million was revised downward to allow the Commission to transfer funds "not to exceed $10,000,000" from technology to meet personnel costs.[5]

The Commission has taken a liberal view of the term "information technology" stated in the appropriations. Essentially, the Commission believes that every bit of technology ranging from our servers and network to copiers, telephones, blackberries and desktops fit within the definition of "information technology." While the Commission is able to include contractor services ($47.8 million) in the technology budget, it does not do so for federal salaries ($29 million).

The technology account is surprisingly personnel intensive. Combining the numbers for federal staff and contractors, the Commission pays 76 cents of every technology dollar to staff, with the remaining 24 cents for actual technology.

Personnel Impact on Technology Budget

	FY 2012	FY 2013 CR	FY 2014 Request
Overall IT Budget	$66.1 M	$64.4 M	$102.0 M
Contractors w/in IT Budget	$33.7 M	$29.5 M	$47.8 M
Federal IT Staff	$15.0 M	$19.4 M	$29.0 M
Remaining for Technology	**$17.4 M**	**$15.5 M**	**$25.2 M**

What, then, is left for new cutting-edge technology? Based on the FY 2014 proposal, the budget provides about 50 percent ($51.4 million) of the total IT budget ($102 million) for "Data Infrastructure," which the proposal explains as "delivery of services around network

[3] P.L. 112-10, Full-Year Continuing Appropriations Act, 2011.
[4] P.L. 112-55, Consolidated and Further Continuing Appropriations Act, 2012.
[5] P.L. 112-74, Consolidated Appropriations Act, 2012.

infrastructure and operations, telecommunication and desktop and customer services."[6] Subtracting the 50 percent of the $25.2 million non-personnel amount that would go toward "Data Infrastructure," the Commission is left with approximately $12 million for new, cutting-edge technology tools to implement Dodd-Frank as well as to carry out its existing oversight responsibilities.

Granted, technology cannot operate without people and the Commission's existing network is essential to support Commission-wide initiatives, but I believe it is useful to understand how the spending of technology resources relates to Congressional directives and Commission regulatory priorities.

The Commission Needs a Specific Five-Year Technology Investment Plan

Given these significant shortcomings in the current budget request, it is essential for the Commission to develop a credible mission strategy that fully considers how technology can facilitate meeting Commission priorities. I recommend the Subcommittee direct the Commission to develop and submit a detailed five-year strategic plan focused on technology, with annual milestones and budgets. This plan must require each division/office within the Commission to prepare a detailed technology strategy in order to develop a 21st century surveillance and risk management program.

As part of this plan, it is imperative that the Commission provide greater transparency into the use and priorities of technology funding. The opacity of the current submission, which is not limited to the technology budget, provides no sense as to the priorities or initiatives.

Appendix Four in the Commission's budget submission identifies key concepts to develop the technology plan sooner rather than later. The concepts identified in the appendix contemplate industry developments and should be the foundation for the development of our own technology strategy going forward.

[6] FY 2014 President's Budget Request and Performance Plan, pg. 51.

Leveraging the National Futures Association

One other point that I would like to highlight for you as you consider the Commission's budget is the role of NFA. NFA is a self-regulatory organization that enhances the Commission mission by registering, licensing and overseeing over 60,000 registrants in the futures and swaps markets. Its annual budget of $75 million (for FY 2014) enhances our mission, especially in terms of registration and oversight responsibilities.

Soon NFA will also provide surveillance for eighteen of the likely SEFs. NFA has established a rigorous testing and oversight program to ensure it can see all transactions across all SEFs registered with NFA. This capability, which presently is well beyond the technology capability of the Commission, will greatly enhance the Commission's oversight mission. NFA also has primary responsibility for oversight of compliance with the requirements for swap dealers and major swap participants. While it is unclear from this budget submission, I hope the Commission is not duplicating NFA's efforts when staff resources can be used in other areas.

Developing a Rule Implementation Plan

In its Annual Performance Report for FY 2012, the Commission conceded that it met only 44% of its performance goals for the year.[7] The Commission made critical staffing decisions to focus resources on Dodd-Frank rulemakings at the expense of examinations and other pre-existing oversight responsibilities. For example, the report explicitly states: "[d]ue to the priority placed on rulemaking and SDR registration, functions outside those activities, including the review of major DCMs [exchanges], were extremely limited during the fiscal year."[8] This is not encouraging, to say the least.

However, the report acknowledges that "the CFTC is shifting toward implementation of rules, as well as the direct oversight of the swaps market."[9] Although it is unclear from this budget

[7] FY 2012 Annual Performance Report, February 2013, pg. 15.
[8] FY 2012 Annual Performance Report at 32.
[9] FY 2012 Annual Performance Report at 16.

proposal, I am interested to see how the Commission will reallocate its resources to support the new oversight mission.

This shift is being prompted not by a change in strategy, but rather by the reality that the Dodd-Frank rulemaking process for major rules is now nearing its end. To date, the Commission has proposed approximately 65 rules and finalized more than 40 rules. It has also issued over 80 exemptions, staff no-action letters, Q&As and guidance documents. This parallel track of ad-hoc and often last-minute exemptions has made the rules look like swiss cheese, leaving market participants uncertain as to the application of the Commission's rules.

Therefore, putting forth a comprehensive and transparent implementation plan could be very significant in providing clarity and certainty to the markets and helping market participants improve their compliance efforts. Such an implementation plan could be of greatest benefit to end users, which do not have the resources to devote an army of compliance staff to deciphering the Commission's rules. It could also help focus the Commission on its own priorities and facilitate the development of the technology-focused business plan I suggested above.

Sequestration

I would like to make a brief comment about the impact of the sequestration on the Commission's budget. The Commission is an organization of dedicated, professional people. We do not make grants and we cannot delay construction. Federal employee compensation and benefits make up nearly 64 percent of our total spending.

Based on the information provided by the Office of Management and Budget, the Commission will be required to make a 5 percent reduction (or $10 million) as part of its share of the sequestration effort. There are two main factors that will enable to Commission to continue to function without furloughs. First, in FY 2012 the Congress provided two-year funding that has enabled us to break loose of the "use it or lose it" mentality. We have $6 million in carryover balances. Also, for the second year, the Commission has tapped the technology funds to offset staffing needs. So far $5 million has been drawn down and I am told to expect the remaining $5 million to be used as well.

While I don't believe the Commission has made the case for a 50 percent increase in this budget submission, I do value the committed and hard-working staff at the Commission and am pleased they will not be impacted during this sequestration.

Closing

Whether or not I agree with all of the rules, or the process they were developed under, I do have a very strong desire to see the Commission succeed in its mission. I want to ensure the Commission will wisely use the resources it is provided to execute its highest priorities. We must develop technology systems as leverage for our limited staff to oversee high-speed electronic markets. We must do a better job to develop a budget plan that makes the Commission accountable for the funding we request and spend in each division and office within the Commission.

I hope that Congress will direct the Commission to develop such a plan and support our mission by making technology our top budget priority.

Thank you for the opportunity to testify.