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TO CONSIDER THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

MARCH 8 & 10, 2005

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TO CONSIDER THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

TUESDAY, MARCH 8, 2005,

U.S. SENATE,,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,,
Washington, DC

The Committee met, pursuant to notice, at 10:02 a.m., in room SD–106, Dirksen Senate Office Building, Hon. Saxby Chambliss, [Chairman of the Committee], presiding.

Present or submitting a statement: Senators Chambliss, Lugar, Harkin, Leahy, Conrad, and Salazar.

STATEMENT OF HON. SAXBY CHAMBLISS, A U.S. SENATOR FROM GEORGIA, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

The CHAIRMAN. The committee will come to order. Good morning.

The authorization of the Commodity Futures Trading Commission, the Federal agency responsible for overseeing the trading of commodity futures contracts, will expire on September 30, 2005. Commodity futures contracts are traded on agricultural, energy, and metal commodities and increasingly on financial instruments, such as instrument rates and foreign currencies. Reauthorizing the CFTC is an important task before the committee this year.

The Commodity Exchange Act is the basic law that empowers CFTC to oversee commodity futures markets. In 2000, as part of the last CFTC reauthorization, the Congress made what most experts agree were landmark reforms in the Commodity Exchange Act by passing the Commodities Futures Modernization Act. The CFMA provided legal certainty for the over-the-counter swaps market and also streamlined the regulatory process for exchange traded futures markets. The CFMA shifted the CFTC away from a prescriptive, rules-based regulatory approach to a more flexible market-oriented approach based on broad core principles.

Since the passage of the CFMA, the industry has seen tremendous growth in trading volume on both the exchange traded futures markets and over-the-counter derivatives markets. This year, as part of the reauthorization process, the committee will review the Commodity Exchange Act, as amended by CFMA, to determine whether additional changes in the law are needed to help CFTC continue to foster open, competitive, and financially sound commodity futures markets and to protect the market users and the public from fraud and manipulation.

Most of the folks I have met with are generally pleased with the Commodity Exchange Act, as amended by the CFMA Act of 2000 and are not seeking many, if any, changes in the legislation this year. We will take in thoughts and suggestions on this important question from a wide array of witnesses over the course of two hearings the committee is holding on CFTC reauthorization this week.

Today, I am pleased to welcome Commodity Futures Trading Commission Acting Chairman Sharon Brown-Hruska and a group of outstanding people from the private sector representing U.S. futures exchanges and the futures industry. I look forward to hearing your testimony.

Senator Harkin has let us know that he will be here. He is running behind, and we have a number of other Senators who have indicated their intention to attend. They will likely arrive as we proceed through the course of this hearing.

Madam Chairman, it is again a pleasure to have you with us this morning. We look forward to your comments and we will take those comments at this time. Thank you.

STATEMENT OF SHARON BROWN-HRUSKA, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Ms. BROWN-HRUSKA. Thank you, Chairman Chambliss. Good morning. I am pleased to be here to appear on behalf of the Commodity Futures Trading Commission to discuss the important issues surrounding the reauthorization of the Commission.

Before I begin my testimony, I would like to recognize and introduce my fellow colleagues on the Commission who join me here today. First is Commissioner Walt Lukken, who is certainly no stranger to many of you on the Hill because of his years of experience working for Senator Lugar and the Agriculture Committee. I would also like to introduce the two newest members of the Commission, Commissioner Fred Hatfield and Commissioner Mike Dunn, both of whom I had the honor of swearing in this past December. I look forward to continuing to work with them and drawing on their considerable insights and experiences. I have solicited input from all the Commissioners in preparing this testimony.

Finally, I would like to recognize and commend the staff of the CFTC. Many of them are behind me. Without their energy and dedication, much of the innovation that the Commodity Futures Modernization Act of 2000 enabled would not have been possible.

Well, it has been just over 4 years since Congress passed the CFMA. While this may seem like a short time, the amount of change that has occurred in the futures and derivatives industry over that period has been extraordinary, and much of that change has been facilitated by the flexibility and innovative foresight of that legislation and Congress for passing that legislation.

Overall, the Act, as amended by the CFMA, functions exceptionally well. The CFMA has provided flexibility to the derivatives industry and legal certainty to much of the over-the-counter derivatives market. This flexibility has allowed the industry to innovate with respect to the design of contracts, the formation of trading platforms, and the clearing of both on-exchange and off-exchange

products. The industry is no longer over-burdened with prescriptive legal requirements and it is able to operate using its best business judgment rather than that of its regulator. At the same time, economic and financial integrity have been safeguarded and the Commission has been able to maintain its ability to take action against fraud and abuse in the markets it oversees.

When Congress adopted the CFMA, it put in place a practical principles-based model and gave the CFTC the tools to regulate markets that were challenged by competition, brought about by technology and an increasingly global marketplace. Since that time when the CFMA was passed, the futures industry, as you noted, has experienced phenomenal growth and innovation. The markets have also become more global. There is more access than ever for U.S. customers wanting to trade on foreign exchanges, as well as for foreign customers wanting to trade on U.S. markets.

One of the benefits that has come from all this innovation and globalization has been increased competition and a lowering of trading costs and an increase in the market quality overall. In addition, new products and new amendment certification procedures in the CFMA have also lowered regulatory barriers and fostered innovation by providing exchanges greater flexibility in listing contracting and in providing them with an ability to react to developments in the cash markets and the competitive markets in which they operate.

We at the Commission are committed to ensuring that our regulatory policies are similarly responsive and that the implementation of the CFMA fulfills the intent of Congress. Competition and innovation must be realized in such a way that customer protection is not compromised and that the financial and economic integrity of our markets is preserved. In that regard, there remains more that we can do as a regulatory agency to move the ball forward even within the current statutory model.

As we begin the reauthorization process, any change should come with careful consideration of potential outcomes as well as unintended consequences that may present themselves. With that in mind, let me highlight three areas of concern on which Congress may wish to focus as it deliberates during the reauthorization process.

First, Congress may wish to evaluate whether clarifications are necessary to the legal framework provided for exempt markets.

Second, Congress may wish to suggest ways that we can more effectively avoid duplicative burdens on the markets and, going forward, provide us with guidance and support as we seek to work with other agencies and with other jurisdictions.

Finally, we at the Commission are cognizant of Congress's firm commitment to ensuring that customers are protected from fraud and manipulation, and to that end, Congress may wish to review whether the CFTC has clear and adequate authority to police retail fraud, particularly in the foreign exchange markets.

In the wake of the Enron collapse and in response to recent run-ups in prices of natural gas and crude oil, there have been calls to increase the CFTC's regulatory authority in the energy sector. Some have called for retrenchment and a return to the prescriptive forms of regulation, like adoptions of federally determined price

limits and position limits. Others have called for more sweeping legislative changes that would give the Commission greater reach into the proprietary and bilateral markets.

As you consider the appropriateness of such proposals, I would ask that you keep in mind that the CFTC has responded decisively to prosecute wrongdoing in the energy markets. The Commission has acted resolutely in the energy markets, demonstrating that its authority is significant and that it intends to use it. The CFTC successfully pursued a complaint against Enron for manipulation of the natural gas markets. In addition, the Commission has filed and continues to pursue various actions and investigations in the energy sector against both companies and individuals.

In addition, the CFTC has recently promulgated regulations clarifying and detailing its authority regarding exempt markets, including certain energy transactions, to better ensure that these markets remain free from fraud and manipulation.

We are aware that last year's energy bill contained several provisions that would directly affect the CFTC's oversight responsibilities and we believe that it is appropriate and timely for our authorizing committee in Congress to consider and weigh in on those proposed changes.

In the security future products area, as you know, the CFMA was noteworthy, in part because of Congress's decision to permit the trading of futures on single securities under the joint jurisdiction of the CFTC and the SEC. However, more than 4 years after the CFMA's passage, the growth of single-stock futures trading continues to be modest, at best. In December, the NQLX exchange, one of the two exchanges that had been offering single-stock futures, suspended trading.

Now, it has been a source of some concern that this sector has not been more successful, and despite the best efforts of the Commission, the CFTC, and the SEC, has not really fully achieved the goals of the CFMA. In many areas, however, I am pleased to say that the two agencies continue to work together to establish regulatory approaches that avoid duplicative regulation and registration.

The CFMA also clarified that the CFTC has jurisdiction over retail foreign currency futures and options contracts, whether transacted on-exchange or over-the-counter, as long as they are not otherwise regulated by another agency. However, as demonstrated in the recent adverse *Zelener* decision, a case litigated by the Commission, the CFTC continues to face challenges to its jurisdiction based on how retail forex transactions are characterized.

We at the Commission have been and remain committed to protecting retail customers against the kind of egregious fraud we see in the forex area. Our track record in the forex area is favorable. Of the 70 cases that we filed thus far, the Commission has lost only three.

As noted, it has only been just 4 years since Congress enacted and the Commission began implementing the CFMA. Given the progress made and the lessons learned, Congress may determine that it is premature to open the Act to significant changes. The Commission has been able to effectively work within the current structure of the Act to police markets, to ensure the integrity of the

price discovery mechanism, and to maintain the financial integrity of the markets and to protect customers.

The Commission stands ready to offer its assistance as Congress moves through the reauthorization process and considers the range of potential options.

In conclusion, let me say that my fellow Commissioners and I welcome this opportunity to work with you on the reauthorization of the CFTC. I greatly appreciate the opportunity to testify before you today on this important matter, and I would be pleased to answer any questions that the Commission may have. Thank you, sir.

The CHAIRMAN. Thank you very much, Madam Chairman.

[The prepared statement of Ms. Brown-Hruska can be found in the appendix on page 46.]

The CHAIRMAN. You detailed several areas of concern that exist between the jurisdiction of CFTC and the SEC. How big is this problem and is it appropriate to try to legislatively resolve these areas of concern? Do you have an ongoing dialog with the SEC to such an extent that you think that is the best way to resolve these concerns?

Ms. BROWN-HRUSKA. Thank you for that question, sir. Actually, in many respects, we have attempted to work within the CFMA to resolve a number of outstanding issues. The SEC and the CFTC fundamentally disagree on some sections of the Act in terms of what is required of us. For example, on foreign security indices and allowing them to be offered to U.S. customers, and what constitutes a narrow-based versus a broad index, the SEC has basically come to a position that they want a very high level of scrutiny. They have to be a certain liquidity and a certain size, and ultimately, what that means is there are a number of market participants who are unwilling under those conditions to offer those foreign security indices.

On other areas, we have, in many cases, been limited. In many cases, the SEC and the CFTC have done the best they can to come to agreement on some difficult issues. Some of it is fundamental differences between the way futures markets and security markets are regulated and are in many ways the systems that we use to ensure performance and operational efficiency in the market.

One of those areas is in margins. We looked at the CFMA. If you look at certain sections where SFPs are discussed, it says that margins in security futures have to be consistent with those in the security options market. Certainly, that is fine. I understand that that would help to avoid any kind of regulatory arbitrage. In another section of the SEA, it says that margins are supposed to be no lower than the lowest level for security options.

Well, security options, if you sell an option, there is nothing but downside risk on that position. The margin level is set at a fixed rate—it is a floor. If you look at a position in a security futures product, it has both down-side and up-side risk. From a risk perspective, you look at the risk that that position poses to the marketplace, it is much lower than, say, an option—the option position that I described, the short option.

Our problem is that in the futures area, we usually use risk as a basis for determining what margins are. It has been very successful and we have had very few problems in the area of futures be-

cause, in general, the margin levels are set to ensure contract performance and that the individuals who make these contracts will, in fat, follow through. The financial integrity has been protected and we have had a lot of success.

In the securities market, they have yet to come around to the risk-based margining system. They have yet to adopt and embrace portfolio margining as we have in the futures area.

I guess I gave you a very detailed answer, but I would say that there is some language in the CFMA that drove us to not adopt the more risk-based approach that I believe is more sophisticated, it is a proven methodology for determining margins, and we have a lot of confidence in it at the CFTC. There may be some areas within the CFMA where we could tweak that language that would provide some guidance or some movement on the part of the SEC and the CFTC to get to a more sophisticated risk-based margining approach.

The CHAIRMAN. Have you had any dialog with the SEC about any proposed changes of that nature?

Ms. BROWN-HRUSKA. We haven't specifically. I have had a very good conversation with Chairman Donaldson about security futures and about commodity pools that are registered with the CFTC, and many of them would also fall under the recent hedge fund registration requirement that the SEC has promulgated. We have talked about security futures products and I have talked with him about margining and portfolio margining. They have some very competent people over there that they have recently hired that are very interested in portfolio margining.

Fundamentally, Chairman Donaldson is very concerned about ensuring that his markets and our markets are free from fraud and manipulation, are full of financial integrity, and my gut feeling is that he would be very open to a discussion and a dialog going forward to make it possible that we can get the regulatory model for SFPs into a better place.

The CHAIRMAN. You made a very correct statement when you said that we want to make sure that there are no unintended consequences that come out of this legislation, particularly any changes that might be made to the existing legislation. That is always a concern and is a real problem, unfortunately, with a lot of legislation that comes off the Hill. Can you think of any unintended consequences that came out of the CFMA that you are having to deal with now?

Ms. BROWN-HRUSKA. That is a very good question. You know, I would say I can't think of any in general. The CFMA has performed extremely well. Usually, when we think of unintended consequences, we think of negative impacts on the market, and I can generally think of only positive impacts. The CFMA did enable innovation and it did give the CFTC significant authority to go after fraud and manipulation. We have done so. Even when we have seen some problems in the marketplace, some bad actors who are intent upon breaking the law, that is what they did. They broke the law. The law as enumerated in the CFMA, we were able to go after those individuals and entities and have had a very successful enforcement record in that area.

The CHAIRMAN. I have some other questions, but I want to give Senator Lugar an opportunity to proceed, so Senator Lugar.

STATEMENT OF HON. RICHARD LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. Thank you very much, Mr. Chairman. I appreciate your testimony. I would just say, as an historical anecdote, that when I came on the committee in 1977, Senator Herman Talmadge, who was our chairman, another distinguished Georgian, pointed to Senator Leahy of Vermont and to me to shepherd CFTC and FIFRA, the Fungicide, Insecticide, Rodenticide Act. These were the areas in which no other member of the committee had particular interest, nor did, the Chairman.

[Laughter.]

Senator LUGAR. In any event, in these uncertain fledgling hands, all this came, and so I appreciate especially your tracing the history and, of course, what I think of as the culmination of this in the Act that was passed 4 years ago. Around this table, many members of the industry came a year before that just simply to philosophize about, in the best of all worlds, what the regulatory act and its reauthorization should look like. Members devoted a lot of time to it, as did members of the Banking Committee, and there was active consideration, as you recall, with the SEC and their interest.

When the Chairman asked, were there unintended consequences, and you pondered and could not think of any, this is reassuring 4 years down the trail.

I pay tribute to one of your colleagues, Walt Lukken, who was a member of our staff and certainly a vital factor in that legislation and I appreciate his presence this morning.

Let me return to a point that you took up because it has been a source of comment in various post-mortems of the Act and that is the whole area of energy regulation. Fairly early in the game, energy was taken off the table, at least in terms of CFTC jurisdiction, and has, by and large, not remained that way. You pointed out that there are powers under the Act now and you have successfully prosecuted a large number of individuals. You have taken a look at the Enron company specifically, as you mentioned.

Energy, obviously, in all of its aspects, is different from corn and soybeans or various other things with which you have dealt successfully. I have always continued to be one to raise the issue of energy because prior to Enron, it appeared to me, at least from testimony that we were getting, that the potentialities for severe damage to the American economy were there. Perhaps CFTC was not responsible and should not be. Others might have taken this up, but others didn't. As you read the 20th book on Enron and all of the lack of regulatory responsibility, this is a severe indictment of government generally that cost a lot of people their jobs and their capital, leaving aside prosecutions that are still underway.

I hope you will continue. I am not going to make a suggestion for amendment of the Act because the complexities technically of doing this, I understand, having heard a lot of testimony on it. At the same time, I would just simply be remiss not to echo that concern that we have suggested in the past, because I am not certain

that area is quite tied and bolted down in a way that is satisfying. By that, I don't mean in a way that stultifies in any way the energy markets, entrepreneurship, careful of resources, but those considerations are there for every commodity that you are dealing with. Energy commodities are likely to be an increasingly competitive and difficult area.

In my Foreign Relations Committee work, we are hearing testimony, for example—these are not unique situations—of China and India seeking almost every last Btu of reserves anywhere in the world for dynamic economies that are going to have huge demands, with a third of the world's population heating homes sometimes for the first time and driving cars, quite apart from manufacturing. These are other alternative energy sources than the ones that you might be regulating, but I just sense that this is going to become a much more competitive situation, politically more volatile as the prices rise. Then there are charges of spiking or that people are speculating on political unrest or suppositions. This may be an area that is within your purview and maybe not, but I simply, as a friend of CFTC, mention that I hope that you will be observant, along with the Commissioners, of this particular area.

Let me just ask as a housekeeping question, is your budget OK? Do you have enough money to run the agency? Are you employing successfully and finding the people that you need for this increasingly sophisticated work, because the industries involved want to have confidence that in your hands, you have the best people and that they are adequately taken care of.

Ms. BROWN-HRUSKA. Thank you so much for your comments, Senator Lugar. I also appreciate having Commission Walt Lukken now in my camp. He is tremendous good help and a great colleague.

In response to your question, I would say that on the budgetary front, we had some problems retaining and keeping good staff. One thing about derivatives, futures, and options markets, it is a complex business and there are lots of different types of markets and some of them are based on interest rate products. It is a sophisticated pricing mechanism, and some are based on currencies, and then we have pork bellies and the whole gamut.

It has been the case that we would sometimes train and bring along very good, qualified people and they would go and leave and go to other agencies. As a way to stem that loss of good people to other financial agencies, we implemented pay parity and that is in thanks to Congress for providing us with our authority to do that. We are able to raise the pay levels to that of the other FIRREA agencies. That is, to raise salary levels to the other financial regulators, even though we are still somewhat behind the Fed and Treasury and the other agencies. We have caught up enough where we have stemmed that loss, of individuals.

Well, when we implemented that, that cost money, and so we have had to really tighten up on our use of resources. We have become extremely efficient to ensure that we maximize our resources.

That said, Congress has been very supportive. The President's budget has delivered for us some sensible numbers that will enable us to operate next year, again in a very tight, efficient way. We appreciate your support and your interest and we thank you for your

continued support as we work to try to get the level that the President has requested, because we feel that that will enable us to perform successfully in the future.

Senator LUGAR. Just one more question that goes back also historically to a trauma in the financial community, the long-term capital management difficulties, as you have mentioned, derivatives. All of us around the Agriculture Committee table got an education in derivatives in a hurry. We had regular appearances by Alan Greenspan and other persons who are not usually a part of the agricultural community or even the CFTC community trying to explain how this could happen and how we tried as a world to unravel it once it did without grievous harm.

You have confidence that a long-term capital management scheme, granted, if it is the first time through, always difficult say, well, historically we know what we are doing, but are the controls that you have now, the people that cite these situations, you believe adequate to give assurances? I ask this because rumor mongers last year getting worried about hedge fund operations of all sorts felt maybe bubbles, as they were terming it, might be happening in various places, nothing of the scale of long-term capital management, which we were advised that Nobel Prize winners were busy working on mathematical models that were absolutely certain to work, until they didn't.

I just wonder, what is your confidence level with regard to derivatives, at least on the grand scale of that entire economies?

Ms. BROWN-HRUSKA. Well, I would say that Long-Term Capital Management did speculate in some very illiquid assets globally. They were very aggressive. The problem—and much of this doesn't really fall within the CFTC's purview. Just looking at it—having been one of those rocket scientists myself as a professor—I would look at this and what was going on, and part of the problem, was that the banking institutions were extending a significant amount of credit.

Senator LEAHY. There were several misjudgments here.

Ms. BROWN-HRUSKA In looking at it, that a lot of the over-leverage that was in Long-Term Capital Management—at least I have it on fairly good authority from, as you mentioned, Chairman Greenspan and others—that that now is not the case. Banking institutions have greater controls to ensure that the credit quality and the credit offered to these types of funds is well within their tolerance level and that the risks that are being taken are monitored and that they have controls, risk-management controls.

From the CFTC's perspective, we do regulate Commodity Pool Operators and Commodity Trading Advisors, and have since 1974. They started as basically futures funds that came together to combine investors' money, and institutions who are usually sophisticated, usually wealthy who take these kinds of risks. These investors and institutions are usually what we call credited investors or qualified purchasers that meet high standards set by the Securities and Exchange Commission. What we have seen is that those CPOs and CTAs have generally performed well. They are subject to the NFA, National Futures Association, and the CFTC's recordkeeping requirements, reporting requirements, and they must have internal controls in place.

From our perspective, looking at our experience with regulating Commodity Pool Operators and Commodity Trading Advisors, which are constituted usually as limited partnerships, that would fall under the SEC's definition of a hedge fund—our experience has been that the type of oversight that we have has been successful and has been able to help uncover wrongdoing and misrepresentations. Our experience has been very good and I would suggest that when Dan Roth of the NFA testifies, he will probably also talk about that.

From our perspective, at least that piece of it which are, at least, defined as hedge funds by the SEC, we feel we have a good regulatory program and we feel it has been effective. Our only issue there is that we would try to avoid duplicating our regulatory program over at the SEC. In general, that they have a similar program in mind for hedge funds and it is something that should be considered carefully and we are in discussions.

Senator LUGAR. I thank you for recognizing the alliances you have. NFA, of course, is very important within the industry, but likewise, good friends on the Senate Banking Committee working with this committee. The SEC and the CFTC are not adversaries. When it comes to these global situations, the importance of that communication and common work is so important. I thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Lugar. Once again, I have always been impressed with the intellect and the public commitment of Senator Lugar, but now that I know that as a young Senator you were given the issue of swaps and derivatives and FIFRA to deal with, I am impressed that you ran for reelection——

[Laughter.]

The CHAIRMAN [continuing]. and stayed on the Agriculture Committee, too, Dick.

You mentioned the budget issue. I know one thing we talked about with your predecessor, Chairman Newsome, who obviously happens to be here today, was the issue of pay parity. I understood from Jim, and I would just like your comments very quickly on how you think that has affected your ability to recruit and retain some of the top people, which you obviously need, dealing with the very complex issues that you do.

Ms. BROWN-HRUSKA. Well, thank you very much, Chairman. It was critical to stop the bleeding, in many respects, at the CFTC and to help us get young, well-trained, or older, well-trained, vibrant individuals to come to work at the CFTC, to come to Washington. It has been very successful in many respects and I am delighted to say that we are very close to a point where we can actually go out and hire some new people, and I suspect that where we are right now, we will have a greater pool of talent to draw from. That it has worked very well.

Again, we have to be very efficient in the use of our resources to ensure that we can continue to keep up with the pay levels that we see in other financial regulatory agencies, but by and large, it is working very well. Again, I would thank Congress for their support on this issue and it has been very successful.

The CHAIRMAN. Thank you.

Senator Harkin.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM IOWA, RANKING MEMBER, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Senator HARKIN. Thank you very much, Mr. Chairman. I apologize for being late. I don't know if you have seen the weather out there lately, but it took me an hour and a half to go 12 miles this morning. If someone would run for President of the United States on a platform of getting rid of traffic jams, you would win hands-down. I don't care what party they are in. I would vote for them.

[Laughter.]

Senator HARKIN. Thank you, Mr. Chairman.

In the 4 years since the passage of the Commodity Futures Modernization Act, the options and derivatives industry has seen record volumes and unprecedented competition, leading to new products and lower prices for users of these markets. I want to welcome Chairman Sharon Brown-Hruska, Commissioner Walt Lukken, and our two newest Commissioners, Mike Dunn and Fred Hatfield. Of course, I have to mention that Mike is from Keokuk, Iowa, and has had a long record of service in agriculture and, of course, worked a long time with Fred Hatfield here on the Hill, both when he was here on the Hill and off the Hill, and then with some California agriculture and things like that, so it is good to see you, also, Fred.

Anyway, I look forward to working with all of you on the reauthorization of the CEA. I want to commend you, Chairman Brown-Hruska, for the CFTC's work in implementing and enforcing the CFMA. It addressed some of the critical issues that faced the futures and derivatives markets in the 1990's. We sought to improve the competitive footing of our futures and derivatives industry by reducing regulatory burdens. We clarified some of the legal status of our over-the-counter derivatives transactions, reforming Shadd-Johnson, and some other things.

It has been largely successful in achieving these objectives. However, there are a few areas noted in some of the witnesses that will be here in the next panel, some of their testimony, and some of my own observations.

This country has been rocked by several serious financial scandals the past few years. These scandals have shown that perhaps no segment of the futures and derivatives markets are safe from manipulation. Additionally, with the large expansion in futures and derivatives volume, we need to consider whether the CFTC needs additional tools to keep tabs on the over-the-counter trade in derivatives.

Given the impact that large pension funds, banks, and other financial institutions have on our economy, we should consider whether the CFTC should have the authority to ask for information from those institutions even regarding over-the-counter activities if it might help prevent a financial calamity down the road.

I continue to be particularly concerned whether the CFTC has adequate authority to oversee energy markets. Energy swaps and derivatives have a far more direct linkage to consumers' pocketbooks than other exempt commodities, such as the metals, for example. The 46 energy enforcement cases settled by the CFTC so far

for over $300 million in fines demonstrates that the CFTC has the authority to punish wrongdoing, which you have done, and that the Commission is using that authority. I congratulate you for that.

Still, we need to make sure that Federal agencies have the authority and tools needed to detect and prevent these abuses from occurring in the first place, especially given the fallout they can have for consumers. We need to review the Commission's anti-fraud and anti-manipulation authorities, as well as its enforcement resources, to make sure they are up to the challenge of regulating existing markets. Particularly, I believe we need to consider whether anti-fraud and anti-manipulation authority should be applied to principal-to-principal trades.

Now, in the past, I have said no. I have been on the side of those that said no because these are principal-to-principal. These are, as we said in the past, these are big boys and girls. They know what is going on, and it affects a small segment, large deals. Then again, some of those affect consumers directly in the fallout of those.

Again, we need to consider that again. We had in the past. We didn't, but now, maybe we should, especially since we are having so many dealings taking place on the electronics markets now, as well as broker trades. We have these going on in the electronics markets.

It seems to me that all similar markets, whether they are brokered, electronic, or what, should be held to the same standards of transparency and openness, and so this is what I am going to be looking at as we look ahead on the CEA reauthorization. We would like to have—I would hope that we could have your input on that.

I did read your testimony. I had a lot of time this morning, driving in——

[Laughter.]

Senator HARKIN [continuing]. I did read your testimony. I am just wondering why you aren't yet making any recommendations to us about what changes in the law or tools that the CFTC needs to make sure that it can do its job as effectively as possible. You are the experts, not us. You have the firsthand knowledge, based on experience. As I said, you have already levied over $300 million in fines, so you have a good insight as to what is happening out there. Where is the CEA falling short?

I guess I would just ask, will the Commission be providing this committee with any specific recommendations for CEA reauthorization this year? Will you be providing us with some recommendations?

Ms. BROWN-HRUSKA. We would be delighted to do so. What I wanted to outline in my testimony were the areas of concern that we had, and I am sure that they are the same areas of concern that you have. We have in the past—for example in the energy area—reached out to this committee to try to provide it with a number of briefings and background on how our cases are going and where we have had difficulties in bringing those cases. I really appreciate the fact that this committee has been so open to our views and I appreciate your mentioning our expertise in this area.

The reason that I didn't come out of the blocks bringing specific recommendations is that I thought it would be of value to hear from the industry. In terms of for example, you mentioned prin-

cipal-to-principal energy transactions—ultimately, it is Congress that needs to decide whether or not the CFTC should be in the middle of a dispute between Royal Dutch Shell and Goldman Sachs. When you have the big boys that are doing these large transactions, that they have a lot of facility and a lot of ability to protect themselves against each other. They wouldn't agree to do the transaction if they didn't think that the price was a fair one. They wouldn't transact with each other if they didn't know what they were getting into.

In many respects, the reason that the Commission hasn't brought to you a specific recommendation in this regard is we think that this is an area that Congress should provide us with guidance. Now, we can give you some language. In fact, the energy bill, as I mentioned before, had some language that we felt, by and large, provided some clarification that would on a marginal basis help us ensure that we can succeed in court if we should bring a case. For the 2(h) markets specifically, which are not intermediated, if you will look at our fraud authority in the 4b area, it says fairly clearly that our fraud authority applies to intermediated transactions.

We thought there is a question of whether it is clear that Congress reserved fraud authority for the Commission in the energy markets in the 2(h) language. Those markets are multilateral, or bilateral markets, and as you mentioned, electronic. They are not intermediated. The 4b fraud statute applies to intermediated transactions. We wanted to lay it out and provide you with our views and we will be glad to circle back to you and to this committee with our assessment of those changes.

Senator HARKIN. I look forward to getting that and looking at it and discussing with you and other Commissioners as we proceed on this reauthorization.

Like I said, I don't know myself. I am still a little uncertain about this myself. I thought I knew where I was before, but I am not certain about it right now with some of the fallout on some of these things as it affects consumers, which brings me to my next question.

We are very sensitive in the Midwest about natural gas prices, both in terms of heating in the winter, but also for fertilizer production, and there has been great volatility in the natural gas markets recently. I have heard a lot of complaints from our fertilizer industry, especially, on this.

I don't know what has caused all this. It seems to me that information regarding supplies are inadequate, that for some reason, the natural gas industry is not as openly transparent, perhaps, maybe even as the oil industry is as far as the different sources of supply and things like that.

It just seems to me that we have a situation here where the CFTC might want to look at some of the limits on trading on natural gas, whether they are set too high. I am told the price limit is now $3 per day. Actually, I am told it is more than just per day. It is just for a few minutes or something like that, like 15 minutes. In other words, if the limit was reached, unlike commodities, some other commodities, which close it for the day, this only does it for a short amount of time. I could be wrong on that, but that is what I am informed, anyway. That limit has never been reached on that.

I am just wondering if we need better limits and if this is some area where the CFTC should be paying some more attention, I guess, on the volatility, what is happening in the natural gas markets.

Ms. BROWN-HRUSKA. That price limits are an imperfect way of controlling volatility. That is one of——

Senator HARKIN. It is just for cooling. It is just to let things cool off a little bit, right?

Ms. BROWN-HRUSKA. Yes. I guess that that is the theory.

Senator HARKIN. That is the theory.

Ms. BROWN-HRUSKA. What it does is if you shut down trading, if you have a price limit that is extraordinarily tight, if you make them tighter such that they are constantly—or if it is such that they are being kicked in frequently, it does have the effect of stopping trading in just the regulated futures markets rather than in, say, the over-the-counter markets and in the cash markets. A lot of the trading will continue to take place, in many cases, in those other markets and the markets get disconnected. It actually creates some underlying inefficiencies in the regulated market, which are very transparent in their publication of the prices on an interminute basis. You can see streaming quotes of prices in natural gas on your computer at any given time.

I would say that—generally, you mentioned about volatility and high prices, and I agree completely with you that nobody is enjoying the high prices that we have been seeing in the natural gas area because it does cost important segments of our economy greater—it raises their cost and then it makes it not feasible to do some of their activity and so it does have a negative effect.

Senator HARKIN. It is not just the high price, it is the volatility of those prices that causes so much uncertainty in the industry out there, even for any kind of forward contracting or anything. There is just this huge volatility.

While I agree with you that if you set limits too low, that stifles the—it stifles all kinds of innovations and everything else. Then if you have them too far apart, then you get this huge volatility swing all the time. Surely there is some middle ground someplace that we could reach on this. I don't know.

Ms. BROWN-HRUSKA. Well, there has been a substantial amount of research that has looked at this. To see whether price limits do, in fact, help control volatility. Sometimes it actually leads to an increase in volatility because traders anticipate that they are getting closer to the limit and they will start to trade out more rapidly of their position because they don't want to be caught with an open position when that price limit comes in because then they can't get out. They are actually stuck with risk, so it creates risk. It creates some systemic risk for the markets. It is not clear that, in some cases, the limits, actually increases volatility.

Senator HARKIN. Good observation. That is why I said we need to look at this some more.

Ms. BROWN-HRUSKA. Well, we are looking at it.

Senator HARKIN. I haven't really seen much from CFTC on natural gas, though. I just really haven't seen a lot. Maybe there is and I am just not that aware of it. I am really taking a look at some of the——

Ms. BROWN-HRUSKA. Well, we certainly have looked at a lot of individual episodes of volatility recently where we have seen huge run-ups.

Senator HARKIN. Yes.

Ms. BROWN-HRUSKA. Then I would say that we do that in a lot of markets. We do that in other markets that are important to you and your constituents. I know we look at cattle. We look at grains. Sometimes we have big run-ups in grains and we have to look at those. I would say that a lot of the evidence and what we have seen in these markets are consistent with the energy complex, as well. We see similar situations where when there is uncertainty about supply and demand, that we see greater volatility. Really, in the energy space, we have very tight supply and demand conditions.

We have a problem with not enough supply, and storing natural gas is a problem, and providing it in the seasonal way that it is demanded has also been an issue, where we see that reflected in the prices. We see a lot of market fundamentals creating this volatility.

Senator HARKIN. You put——

The CHAIRMAN. Senator, can I interject something quickly? This is a critical area. Your questions have been right on point, Tom. One of the criticisms that has been directed at the Act itself is that it allows the natural gas market to be manipulated rather than supply and demand forces work their way. I know CFTC did an investigation a year or so ago, or you have been doing it over the last year, relative to this issue. Can you give us some of your comments regarding manipulation versus supply and demand creating these volatile highs and lows that Senator Harkin is talking about?

Ms. BROWN-HRUSKA. Well, I can speak generally. We have completed our investigations that have looked in those episodes. We had one last fall. We had one the year before that. In every case we look at, we are grateful that we have, in fact, a significant amount of information on the positions of large traders, of energy market participants, of users, to determine what their intentions are and what their trading activity is. It is our Large Trader Reporting System. We evaluate that trade. We evaluate the audit trail and the prices that we see to determine if there was any strategic manipulative behavior.

In both those investigations, we found a lot of supply and demand-type explanations for the volatility and the prices that we saw. For example, we could link it directly to, in some cases, unrest. If you look at crude oil, we could look at situations in the Middle East where we had some concerns about supply there. If we look at natural gas, it is the winter heating season. In this last fall, uncertainty about what the weather would be like and whether or not supplies would be able to keep up with those weather conditions clearly predicted some of the price patterns that we saw.

We use all the data that we have at our disposal and all the information that we can get, and you mentioned, Senator Harkin, over-the-counter market positions. If we suspect that somebody is trying to manipulate the futures markets so that they can benefit themselves in their over-the-counter market or their cash market position, we can get that information. We can do a special call, and we do them all the time to get the information that we need to en-

sure that they are not using the concert of two markets to manipulate our markets.

I would say, by and large, that we have and we will continue to investigate unusual price activity. We will tie that in with our significant resources in the enforcement and in the surveillance area to ensure that the markets are not manipulated and we do that in a very proactive way, I would add. We see it on a day-to-day basis. If something is going on in the markets that is a concern to us, we immediately start watching those markets. We are in touch with the regulatory officials at the exchanges to try to get an understanding of what is going on. We work with them. If they want to raise their margin levels due to the increases in volatility and concerns that they have, we support that. We work with them to identify who the traders are and what their intentions are.

I would say, by and large, we have been very successful, and part and parcel to that is because of a good working relationship that we have with the markets, with the exchanges, particularly, but even in the over-the-counter markets, that we do have special call authority and we don't hesitate to use it.

Senator HARKIN. Thank you, Mr. Chairman. Thank you for asking that question. You can see that—I was listening to Senator Lugar's questions, also. As we go down this path on the reauthorization of the CEA, energy markets are going to be one big thing that we are going to have to wrestle here as to what authority CFTC, if any—I am not even certain about that—what additional authority you may need to get data. If you say supplies are tight, do you really have the tools that you need to get that kind of information to know whether or not the markets are transparent, really transparent or not?

I am not convinced of that right now, and so my questions as we go forward are going to be around that area. Of course, I focused a little bit on natural gas. I just might focus on other things. It seemed that we had great volatility there. The spreads are too wide. There is great uncertainty as to what the data shows in terms of supplies out there. Again, I just wonder, Mr. Chairman, whether or not CFTC might need some additional authorities in that area. Like I said, I don't know the answer to that question, but we are going to have to pursue it.

Thank you, Mr. Chairman.

[The prepared statement of Senator Harkin can be found in the appendix on page 42.]

The CHAIRMAN. You are absolutely right. As we go through this process, we have to wrestle with this issue. Madam Chairman, those of us on this committee can pretty easily follow what the planting season portends, what the harvest is, and what the drought situation is, so we can follow commodities, agricultural commodities. Something like natural gas that doesn't have an annual harvest season, it is obviously much more difficult for us to give any oversight. That is why we have CFTC. We would urge you to continue to be proactive and to keep us advised and to dialog with us as we go through this process to make sure we are doing the right thing legislatively.

Senator Salazar.

STATEMENT OF HON. KEN SALAZAR, A U.S. SENATOR FROM COLORADO

Senator SALAZAR. Thank you, Mr. Chairman, and thank you, Senator Harkin. Congratulations to you, Chairman Brown-Hruska, on the fine job that you are doing.

I realize that CFMA has a relatively short life span. You have only been working with the reauthorization for the last four or 5 years. I appreciate the great work that you and the staff and the Commissioners have been doing.

I also am going to be a supporter of the reauthorization, because you have been doing a great job. Following along the same lines of questions that were being asked by Senator Harkin, it would be a good time for you and the Commissioners to look back to see whether or not there are lessons to be learned from the last 5 years of what has happened with respect to some of the scandals that we have seen in other aspects of our financial markets and if there is anything that we ought to be doing as a Congress to try to address those issues.

I come from a background, for the last 6 years, I spent my life as Attorney General. In that regard, I was very involved in investigations and prosecutions relating to the mutual fund industry as well as talking to some of my colleagues about some of the improprieties that occurred on Wall Street.

You have been doing a very good job with respect to the kind of reauthorization and the right kind of enforcement and I very much appreciate that. It would be very useful for us as a Congress to have your thoughts, as the Chairman of the Commission, on whether or not there are any changes that ought to be made to avoid the kinds of problems that we saw, for example, in the mutual fund industry. My own view of what happened in the mutual fund industry is that we had regulation and we had regulators, but we didn't have the right kind of enforcement so that we ended up having the kind of preferential treatment that allowed the market timers to come in and to basically take advantage of the ordinary mom-and-pop Americans that were investing in their 401(k)s and in their mutual funds.

My own request of you is that you think long and hard, now that we are going through this reauthorization process, and use it as an opportunity to make sure that among commodities trading, that we don't have the same kinds of problems that we had in other aspects of our financial markets here in America.

Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Salazar.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. Thank you, Ms. Chairman. Is that the appropriate appellation, Ms. Chairman?

Ms. BROWN-HRUSKA. Madam Chairman.

[Laughter.]

STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you very much for being here. Let me, first of all, associate myself with the questions of Senator Harkin, because they were right on target.

Let me just say that I had an opportunity to meet with industry experts on natural gas in the last day and a half and they tell me they think we are poised to have very substantial upward movements in the natural gas market. We look at what is happening with the snowpack out our way. That means—the snowpack is way down. That means production from our main stem dams on the reservoirs is going to be down. That means more pressure on natural gas. We have, as you know, lots of other pressures on that market.

Senator Harkin was absolutely right to be focusing on volatility in natural gas. I want to make clear that I share his concern.

I want to turn to another area of concern and that is exchange rate contracts and how much risk is being run there. What I am most interested in is what would happen, in your judgment, if there were a precipitous fall in the dollar? The reason I ask is we have already seen the dollar come off the Euro about 30 percent in the last 2 years. There seems to be continuing pressure on the dollar as we continue to run massive trade deficit. As you know, the trade deficit was over $600 billion last year. The operating deficit of the United States was over $600 billion last year. That includes the money that we are borrowing from Social Security and have to pay back that is not included in what the press defines as the deficit. On an operating deficit, the truth is, we are running about a $600 billion shortfall there, as well.

Much of that is being funded now externally. Over the last 3 years, our foreign indebtedness has gone up 91 percent, quite stunning. We had, 3 years ago, a trillion dollars of foreign indebtedness. Now, we are approaching two trillion of foreign indebtedness.

We saw 2 weeks ago, South Korea sent shudders through the market by announcing they were going to diversify out of dollar-denominated debt and dollar-denominated securities, that they thought the risk was growing unacceptably given our budget and trade deficits.

We have had Warren Buffet, one of the most successful investors in our country, indicate that he is placing major bets against the U.S. currency. We have seen others similarly indicate growing concern. I understand there was a delegation from Japan here last week warning the United States that we could not continue to run these massive deficits. As you know, we have already borrowed over $700 billion from Japan alone.

The vulnerability and the risk here, it strikes me, in these exchange rate contracts is if there were a precipitous fall in the dollar, and many economists are warning us that that could occur. What are the protections in place against the chaos that would ensue if there were a precipitous fall in the dollar?

Ms. BROWN-HRUSKA. Well, I would say that the last time I taught this—I taught international finance, so I remember the data of the last time I looked at it, and your data sounds much more up-to-date than mine—but I remember that, in fact, the vast majority of the foreign currency traded in the world used to be about $4 trillion a day, in the interbank currency markets and largely outside of our jurisdiction.

A lot of that is hedged in forward and swap transactions. In the forex area, the swaps transactions are largely designed to help companies manage the mismatch between their foreign currency

cash inflows and their foreign currency cash outflows that they have as a part of doing business.

What typically is the case is that to swing back to your question, of the regulated foreign currency transactions that we have oversight of. They are probably on the order of two or 3 percent of the total foreign currency transactions that take place.

I am very confident in our market's ability to continue to provide risk management regardless of the direction of the U.S. dollar. That is the key thing. Derivatives provide a way to manage that uncertainty about where the dollar is going, and so it is vitally important that they be allowed to function so that businesses, from the smallest operation to the largest, be able to rely upon those marketplaces to hedge those risks.

Senator CONRAD. Let me interrupt you there because I am running out of time. In fact, I am out of time, Mr. Chairman. If I could just conclude with one question?

The CHAIRMAN. Sure. Go ahead.

Senator CONRAD. Let me just—I am told that this recent court case, the *Zelener* case, that the court held that these exchange rate contracts are not futures contracts and therefore not subject to CFTC regulation. Is that an accurate depiction?

Ms. BROWN-HRUSKA. That they are not futures contracts? Yes, that is accurate.

Senator CONRAD. Yes, and so not subject to CFTC regulation.

Ms. BROWN-HRUSKA. Yes.

Senator CONRAD. Who does regulate them?

Ms. BROWN-HRUSKA. Well, in fact, we brought a case for fraud in that particular case, so obviously we believe that we regulate them.

Senator CONRAD. Yes, but the court says no.

Ms. BROWN-HRUSKA. Again, yes, this has been a very difficult court case. In fact, we appealed it all the way up to the Supreme Court. It is one of those situations where they focused on the language of——

Senator CONRAD. I know, but I don't want to go into the detail. I want to know where we are now. What concerns me, and what has to concern this committee, I would say to my chairman, is if you all don't regulate these contracts, who does? You say you are confident of where we are. Well, I will tell you, if nobody is regulating these things, I am not confident, and there is too much risk out there to be confident, it seems to me, if we have a court decision that says you can't regulate these contracts.

Ms. BROWN-HRUSKA. Well——

Senator CONRAD. That is the court determination, right?

Ms. BROWN-HRUSKA. It was one court, yes. We are——

Senator CONRAD. We are stuck with that until some other court makes some other determination or, perhaps, until we act. Is there any requirement that Congress respond to this, or can you give advice to us? It doesn't have to be now. Perhaps you need to consult with others.

What I want to make sure we get on the record here, Mr. Chairman, is does Congress need to act in response to this court decision to make certain that CFTC has jurisdiction in this area? Do we need to do that?

Ms. BROWN-HRUSKA. Well, I would say that yes, we are looking at it and our intention is to continue to bring these cases. I just signed three of them yesterday, where we were taking action against——

Senator CONRAD. I appreciate that, but we have a problem here, don't we? We have a court that said, these are not futures contracts. My time is—I have gone over my time. Let me just conclude by saying, Mr. Chairman, we need to really insist that we get a recommendation on what action we might need to take in response to that court determination. I don't want to leave you without the authority to be examining these contracts. The risk is simply too great.

Ms. BROWN-HRUSKA. Thank you, sir.

Senator CONRAD. I thank the Chairman.

The CHAIRMAN. Very good question. Let me just suggest, Madam Chairman, that you have your staff put together the issue that now you are faced with after the decision in this case and give us your recommendation on that issue.

Ms. BROWN-HRUSKA. Thank you, sir. We would be happy to.

STATMENT OF HON. PATRICK LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. Senator Leahy.

Senator LEAHY. Thank you, Mr. Chairman.

The CFTC is one of the few Commissions where I have worked with a majority of the Commissioners, most of them former Hill staffers. I also want to commend the Acting Chair, Ms. Brown-Hruska. She has done a great job in her leadership role, and I know a number of these issues have been raised already.

As I look around, I see Mike Dunn, who worked extensively on agriculture credit and banking issues when I was chairman. Commissioner Walt Lukken did a fantastic job on the last reauthorization of the Commodity Exchange Act. Fred Hatfield worked with Senator Breaux, and Doug Leslie, who was on loan to me and Senator Lugar for around 2 years assisted this committee.

I know that former Chairman Lugar has talked already about when he and I volunteered—that is the day we arrived 1 minute late, Dick——

[Laughter.]

Senator LUGAR Senator Talmadge volunteered us to take on the CFTC thing. I ended up learning more in a short time than I ever thought I would.

Senator LEAHY Madam Chairman, I appreciate your effort to close down some of these boiler room operations. What they do, and usually to the most—what they bilk people out of, and they are usually the people who can least afford it. People who deal on a professional basis on commodities know the risks. They deal with millions of dollars, sometimes hundreds of millions of dollars back and forth, but that is a business. They know how to deal with the risk. They know how to handle it.

When you are a person on a fixed income or you are a person who gets a call from one of these boiler rooms, it doesn't work that way, and especially if you have a family who is desperate. They may have both parents holding down jobs, trying to make ends

meet. They get some of these calls, and you have heard probably more of them than I have, but I have listened to some of the recordings and being lured into foreign exchange markets. You and I know enough to hang up on it from our own past experience, but a lot of people don't and they just go into ruin. They have to be closed down totally.

I have worked on both the Appropriations Committee and the Judiciary Committee to give funding to the Justice Department for people designated to work on specific issues and I am happy to work on this.

Now, there are other areas, the Enron collapse. I am very concerned about energy markets. We see the price of oil going up. This could affect, whether it is in a rural area like mine or a major population area, the energy markets make a determination whether they are going to make it or not, whether they are going to have jobs or not. It is vital to be able to protect us on these markets, especially in the anti-fraud, anti-manipulation efforts.

The CFTC needs a stronger oversight role regarding over-the-counter foreign exchange and options contracts. I know it is a complicated issue. When I came in, somebody mentioned the Seventh Circuit case, *Zelener*. Let us work together. Let us work together on this.

My question would be about the over-the-counter forex, the foreign currency exchange. Are you getting the kind of help you want from the Department of Justice in putting these people out of business?

Ms. BROWN-HRUSKA. Well, thank you for your comments. You know, we have a number of open forex investigations with the Department of Justice now and we very much appreciate it. We have been very well received by Justice and our cooperative efforts have paid off, not only in forex, but in the energy investigations that we brought, as well.

The Division of Enforcement at the CFTC and the Department of Justice together brought Operation Wooden Nickel last year, one of the largest undercover operations in the history of our agency. In that action alone, over 30 people were arrested. In sum, our relations with Justice have been very good and our markets benefit from that work.

You mentioned also, or someone mentioned States' Attorney Generals. We have also worked with those individuals and their offices as well, to bring a lot of our cases in the energy and forex area.

I said that we might like some clarification in our forex authority, given the *Zelener* case, the States do also have significant authority, the Attorneys General and so does Justice, so does the Federal Trade Commission, if they want to take up some of these cases. In many respects, by cooperative enforcement, we are able to ensure that those late-night cold callers and those Internet fraudsters are tracked down and put out of business.

Senator LEAHY. I am sure you agree with me. We want commodities markets to work. Obviously, when you have an economy like ours, especially one that uses so much from energy to food and everything in between, we want them to be able to work. Everything gets tarnished, at least in the view of the average person, if these

illegal groups are working. I want you to be able to bring the hammer down.

Incidentally, Senator Feinstein has again introduced a bill to regulate over-the-counter energy trading. Have you had a chance to look at that?

Ms. BROWN-HRUSKA. No, I haven't seen the specifics. I know that it—I have seen her past legislation and some of it was well received in terms of its intent.

Senator LEAHY. We may want our staffs to talk more on that. It is another area, especially after some of the past things, and as energy prices go up, it is something a lot of us here are very concerned about.

Mr. Chairman, I will have other questions for this and the other panel. I will just introduce those for the record. We have a Judiciary meeting going on. I wanted to come down to give my compliments to the Chairman, but also to emphasize, like Senator Lugar already has, that a lot of us, and I know this includes the two of you, we want commodities trading to work. We also want to make sure that those who try to cash in on unsuspecting Americans, that we bring the hammer down pretty hard.

The CHAIRMAN. Thank you, Senator Leahy.

[The prepared statement of Senator Leahy can be found in the appendix on page 44.]

TheCHAIRMAN. We have already publicly stated our admiration for you and Senator Lugar for taking this on early and staying on the committee.

Madam Chairman, thank you very much. We appreciate your testimony and your very frank discussion that we have had here today, and we look forward to staying in touch as we move through this process.

Ms. BROWN-HRUSKA. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. We will now ask our second panel of very distinguished members of the industry to come forward.

Gentlemen, welcome this morning. We are very pleased to have with us Mr. Charles P. Carey, Chairman of the Board, Chicago Board of Trade, from Chicago; Mr. Terrence A. Duffy, Chairman of the Board, Chicago Mercantile Exchange, also Chicago; Dr. James Newsome, President, New York Mercantile Exchange, New York, and obviously the former Chairman of the CFTC; Mr. Frederick W. Schoenhut, Chairman of the Board, New York Board of Trade, of course, New York; Mr. Satish Nandapurkar, President and CEO of Eurex US, Chicago; and Mr. John Damgard, President, Futures Industry Association, located here in Washington.

Gentlemen, we welcome you here this morning. We look forward to your testimony and to your dialog. Mr. Carey, we will start with you. I would encourage all of you to submit your statements for the record. Limit your comments to 5 minutes. Thank you.

STATEMENT OF CHARLES P. CAREY, CHAIRMAN, CHICAGO BOARD OF TRADE, CHICAGO, ILLINOIS

Mr. CAREY. Thank you, Mr. Chairman and members of the committee. My name is Charles Carey. I am Chairman of the Chicago Board of Trade. It is an honor for me to be here today to present

the Board of Trade's views. As you have requested, we have submitted our written testimony for the record.

We commend Congress for passing the Commodity Futures Modernization Act and the careful and thoughtful way in which the Commodity Futures Trading Commission has implemented its provisions. The CFMA gave the Commission needed flexibility to deal with innovation and brought legal certainty to many products while preserving regulatory concepts that are essential to our industry. The Commission and its staff have shown great insight in using this authority to reduce regulatory burdens without sacrificing vital customer protections.

In my written testimony, I call attention to several issues that deserve discussion, but major changes to the law appear unnecessary at this time.

For example, security futures, which were allowed for the first time by the 2000 Act, have yet to reach their potential. Dual regulation by the CFTC and the Securities and Exchange Commission has created challenges. We hope the two Commissions work together to relieve these, such as the unfair and unnecessary margin in equities that inhibit the growth of stock futures and their usefulness as risk management tools.

A Federal court decision holding that the CFTC has no antifraud jurisdiction over retail foreign currency transactions could lead to increased opportunities for fraud. The potential impact of this decision is a matter of concern across the futures industry. Congress may find that this issue warrants a legislative response. If that is the case, the CBOT will, as always, be happy to work with the committee, the Commission, and other industry representatives in creating a solution.

Since the CFMA, a major trend in the industry has emerged toward international expansion and cross-border business arrangements. This trend presents interesting challenges for regulators both at home and abroad.

In one such initiative, Eurex soon will ask the CFTC to approve a plan to approve trades on its U.S. subsidiary contract market through a clearinghouse located in Frankfurt, beyond the regulatory control of the CFTC. The prior Chairman of the Commission told the House Agriculture Committee that such a non-domestic clearinghouse must register with the CFTC as a designated clearing organization. The CBOT believes this is good regulatory policy and will preserve for U.S. citizens trading on Eurex US the protections available under U.S. regulation and bankruptcy law in the event of a default or insolvency.

Recent actions of a handful of traders in London selling and buying bonds through a European electronic trading system are being investigated by four European governments for possible price manipulation. This incident illustrates the potentially destabilizing effect that market behavior can have across borders and between exchanges and marketplaces. Comparable regulation and information collection among regulators of different countries is essential to help detect and prevent systemic harm from such activities.

The Chicago Board of Trade is pleased that the CFTC recently began discussions with the Committee of European Securities Regulators and hopes those discussions will be productive in resolving

issues of regulatory disparities and gaps in a manner consistent with the CFMA.

In addition to customer protection issues, unequal regulatory treatment can also result in uneven regulatory costs, thereby creating unfair competitive advantages. Decisions being made now with regard to policies and protocols for cross-border business are setting critically important precedents that will impact the global derivatives industry for years to come.

The Chicago Board of Trade, the oldest and one of the largest futures exchanges in the world, had its best year ever, trading over 600 million contracts last year, a volume increase of over 31 percent over the prior year. The success of the Chicago Board of Trade over the years reflects the confidence that market participants around the globe have in our commitment to vigorous, even-handed self-regulation.

Self-regulation with Commission oversight continues to work well. There have been questions raised concerning the move by exchanges to become for-profit organizations and whether they can avoid conflicts of interest. A for-profit exchange has an even greater incentive to maintain and increase public confidence. Experience has shown that investors prefer markets that have demonstrated integrity through self-regulation.

The Chicago Board of Trade is presently going through the process of becoming a for-profit organization. I assure the committee that this new status, while enabling us to compete more efficiently with other exchanges from around the globe, will not lessen our dedication to fair and forceful self-regulation. We hope and expect that regulators will keep in mind the advantages of knowledgeable and experienced self-regulation and not impose rigid definitions that, for example, may preclude a member of an exchange with no other ties to the exchange from becoming an independent director or committee member.

Again, thank you for the opportunity to testify today. The Chicago Board of Trade is pleased to respond to questions and provide any assistance the committee may deem necessary. Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Carey can be found in the appendix on page 51.]

The CHAIRMAN. Mr. Duffy.

STATEMENT OF TERRENCE A. DUFFY, CHAIRMAN, CHICAGO MERCANTILE EXCHANGE, CHICAGO, ILLINOIS

Mr. DUFFY. Thank you very much, Mr. Chairman. I am Terry Duffy. I am the Chairman of Chicago Mercantile Exchange Holdings, Incorporated, which owns and operates the largest U.S. futures exchange. I am happy to appear before you, Chairman Chambliss, to offer you and the committee the CME's view as to what the committee should be considering as it undertakes reauthorization of the CFTC.

In the judgment of the CME, the Commodity Futures Modernization Act of 2000 represents successful landmark legislation that materially and beneficially transformed the nation's futures markets. The CFMA's reduction of high-cost regulation has been an un-

qualified success, making futures trading more efficient and useful to a wide range of customers.

Throughout its over 100–year history and especially so in the past three decades, the CME has earned a reputation as a premier innovator and industry pace setter. A very clear demonstration of our leadership in the global derivatives industry is the historic clearing link between the CME and the Chicago Board of Trade, which has delivered on the efficiencies and the $1.8 billion in savings just as promised.

Within our organization, the initials "CME" stand for Customers Mean Everything, and that customer-driven perspective explains much in terms of our success since the enactment of the CFMA.

While the CME enthusiastically applauds the success of the CFMA and recommends that we retain this historic statutory framework, the upcoming Congressional reauthorization process offers a valuable opportunity to fine-tune that statutory regime based on industry experience gained since the CFMA's enactment in 2000.

The first area in need of fine-tuning involves retail foreign exchange futures. There have been massive continuing frauds against retail customers in the OTC FX market. A loophole in the Act permits unregistered known offenders to sell foreign currency futures to naive retail customers. This loophole can and should be closed.

Compounding this problem is the recent unfortunate decision of the Seventh Circuit Court of Appeals in *CFTC* v. *Zelener,* where the court adopted an extremely narrow definition of futures contracts. *Zelener* held that a futures contract stops being a futures contract if the seller inserts a meaningless disclaimer. The ruling permits OTC dealers to easily offer futures-like contracts to unsophisticated customers without the CFTC's jurisdiction or registration requirements. As noted in recent testimony by Acting CFTC Chairman Brown-Hruska, this retail fraud has spread from foreign currency scams to heating oil and orange juice. This can and should be stopped by closing the loophole created by *Zelener*.

Unless the loophole is closed, the committee should be concerned with the very real prospect that, before long, the CFTC's jurisdiction and its retail customer protections may be reduced to irrelevance. The challenge for the committee and the futures industry is to find an effective solution that will politically survive the reauthorization process.

The second area in which the CFMA needs to be modified deals with single-stock futures. Inter-exchange competitive concerns combined with regulatory and legislative turf contests ended the hope for this product long before it was launched. It is time to let futures exchanges trade the product as a pure futures contract and to let the security exchanges trade it as a securities contract. Let the relevant exchanges deal solely with the irrespective regulator, whether the CFTC or the SEC, which is what I believe Congress initially intended in 2000 in authorizing single-stock futures. I would urge the committee to prevail upon the respective regulatory agencies to eliminate all undue regulatory impediments.

Before concluding, Mr. Chairman, I noted that one of the witnesses called for Congress to force exchanges that innovate and pioneer new contracts to freely give up their benefits of the invest-

ment and innovation to competitors. That idea is utterly contrary to every viable economic principle that has made the U.S. economy work.

A number of other issues have been raised in written testimony. I will be pleased to explain why self-regulation in the futures industry works, how our corporate governance meets the highest standards, and why the rulemaking process under the CFMA is not broken in response to your questions or in supplemental testimony.

In conclusion, I want to thank you, Mr. Chairman, for allowing me to participate in this hearing. The CME, its customers, and the industry have benefited greatly under the CFMA. The CME looks forward to participating in the reauthorization process, helping the committee craft amendments that preserve the original intent of the CEA, amendments that protect retail customers and that improve the efficiency, the competitiveness, and the fairness of futures trading for all market participants.

I would be very pleased to answer any questions the committee may have. Thank you, sir.

The CHAIRMAN. Thank you, Mr. Duffy.

[The prepared statement of Mr. Duffy can be found in the appendix on page 60.]

The CHAIRMAN. Dr. Newsome, welcome back.

STATEMENT OF JAMES NEWSOME, PRESIDENT, NEW YORK MERCANTILE EXCHANGE, INC., NEW YORK, NEW YORK

Mr. NEWSOME. Thank you, Mr. Chairman.

The CHAIRMAN. This is the first time you have been here in this capacity, I believe.

Mr. NEWSOME. Yes, sir, it is.

The CHAIRMAN. We congratulate you again and welcome. We look forward to your testimony.

Mr. NEWSOME. Thank you very much. Mr. Chairman, members of the committee, it is an honor to be here as President of the New York Mercantile Exchange today. It is certainly an honor to see friends on this committee and former colleagues at the CFTC, as well.

NYMEX is the world's largest forum for trading and clearing physical commodity-based futures contracts, primarily energy and metals. The Commodity Futures Modernization Act of 2000 was landmark legislation that provided critically needed legal certainty and regulatory flexibility to U.S. futures and derivatives markets. It is our view that the current structure is providing a reasonable, workable, and effective oversight regime for regulated exchanges.

Prior to the CFMA, the CFTC operated under a one-size-fits-all regulatory approach. Regulatory inequities, particularly prior approval requirements for rule and contract changes, imposed unreasonable constraints on domestic exchanges competing with international and unregulated exchanges. This committee and the Congress agreed that the orientation of the CFTC should be shifted to a more flexible oversight role.

To address these issues, Congress established market tiers so that a marketplace could now select a level of regulation according to the product types offered, and even more importantly, eligible participants for the facility.

NYMEX operates by choice at the highest level of regulation by the CFTC. It has consistently been deemed by the CFTC staff reviews to have maintained adequate regulatory oversight and programs. As a result of Congress's foresight and innovation, NYMEX, acting subject to CFTC review and oversight, can now bring new products and services to market promptly to meet customer needs.

Although NYMEX is largely a marketplace used by commercial participants for hedging, the benefits also accrue more broadly to consumers, who receive prices based on open and fair competition. Prices for the commodities traded in U.S. futures markets are vital to our national economy and are recognized as reliable, global benchmarks.

As a note, the CFMA maintained the CFTC's exclusive jurisdiction over futures and options on futures. NYMEX supported and continues to support this approach, which would be maintained by several savings clauses contained in last year's energy bill.

It is important to point out that contrary to what some have suggested, the CFMA did not diminish the regulatory oversight responsibilities of the CFTC. Although regulated exchanges may self-certify new contracts and rule changes, the CFTC retains the responsibility to assure that all changes are in accordance with the guidelines of the Act. In practice, there is always prior discussion with the CFTC on any substantive change.

Regulatory flexibility was vital in responding to the financial failure of Enron. In the aftermath, other energy trading companies lost credit ratings. Stock prices plummeted, and liquidity crises began to develop because market participants lacked confidence in each other's abilities to perform transactions.

In response, NYMEX addressed these issues by rapidly implementing a number of important measures to migrate positions from the over-the-counter marketplace to NYMEX and the protections provided by its AA-Plus rated clearinghouse. NYMEX also began launching a slate of products appealing to OTC participants which are executed off the exchange but brought to NYMEX for clearing. In doing so, 130 products that are traditionally traded OTC have been brought under the umbrella of a regulated exchange, which establishes the identity of participants, a transaction audit trail, daily position surveillance, and credit security, none of which would have been available prior to the CFMA.

NYMEX's safeguards allowed us to maintain solid footing during this challenging time, and thanks to the flexibility permitted under the CFMA, NYMEX adapted and provided the necessary tools to help stabilize impacted businesses.

We recently completed an analysis of hedge fund participation in several NYMEX markets during 2004, which is being submitted to the committee, Mr. Chairman, for the record. As you review this report, I believe you will agree, as our research suggests, that hedge funds serve an overall constructive role in our markets. While hedge fund participation has not made up a large portion of our markets to date, we continue to monitor this market segment closely.

Market integrity continues to be effectively safeguarded on the regulated exchanges through stringent adherence to the CFMA

core principles. As a self-regulatory organization, NYMEX devotes significant resources to the oversight of all of its markets.

With regard to CFTC oversight responsibilities, the agency has been, by all accounts, quite vigorous in exercising the scope of its current authority to police abuses in OTC markets, including energy markets. Nonetheless, there remain open questions respecting CFTC anti-fraud authority over principal-to-principal transactions involving exempt commodities executed bilaterally or on electronic platform. Congress may wish to consider whether clarification or guidance in this area is needed.

As my time is out, Mr. Chairman, I would just say that I appreciate having the opportunity to be here today and I look forward to answering any questions that the committee might have.

The CHAIRMAN. Thank you, Dr. Newsome.

[The prepared statement of Mr. Newsome can be found in the appendix on page 69.]

The CHAIRMAN. Mr. Schoenhut, we are pleased to have you with us.

STATEMENT OF FREDERICK W. SCHOENHUT, CHAIRMAN, NEW YORK BOARD OF TRADE, NEW YORK, NEW YORK

Mr. SCHOENHUT. Mr. Chairman and members of the committee, thank you for this opportunity to testify on behalf of the New York Board of Trade regarding the reauthorization of the Commodity Futures Trading Commission. My name is Fred Schoenhut and I am Chairman of the Board of the New York Board of Trade.

In 2004, the Coffee, Sugar, and Cocoa Exchange, founded in 1882, and the New York Cotton Exchange, founded in 1870, formally became one exchange, the New York Board of Trade. Like its predecessor exchanges, NYBOT is a not-for-profit membership organization established under New York law. NYBOT is the premier world market for futures and options in cocoa, coffee, cotton, orange juice, and sugar. The exchange also has markets in currency rates and equity indexes. While the financial markets exhibit different underlying characteristics than the agricultural commodities that dominate the exchange, they all provide reliable tools for price discovery, price risk management and investment.

In 1994, NYBOT established a trading floor in Dublin, which is the first open outcry trading facility in Europe owned by a U.S. exchange.

The concept of self-regulation long embodied in the CEA was strongly reinforced and expanded by the Commodity Futures Modernization Act of 2000. The CFMA was the culmination of 4 years of work by the Congress. It provided the flexibility for exchanges to decide how best to structure their businesses around a set of core principles.

The CFTC provides oversight rather than promulgating prescriptive regulations and second-guessing exchange decisions.

We believe the CFMA is working as intended, allowing markets to be competitive by modernization and streamlining the regulatory system. We, therefore, support a reauthorization bill that continues this current regulatory structure. In this regard, we wish to point out three areas of the exchange self-regulatory structure that are important to maintain.

First, each exchange should continue to be allowed to determine the composition of its governing board. NYBOT finds that diversification of board membership is beneficial to protect the public interest and the economic self-interest of the markets. It allows each exchange to have a range of expertise on its board, including people who are actively engaged in the trading of exchange products. How board members are chosen and how representation of various exchange communities should be allocated are matters for each exchange to determine for itself in light of its own particular circumstances.

Second, the structure for exchange compliance and disciplinary functions should also remain unchanged. Currently, each exchange is required to have procedures in place for monitoring and enforcing contract market rules. The CFTC conducts regular rule enforcement reviews to determine whether an exchange is meeting this requirement. We believe this current system works well and additional requirements regarding the makeup or functions of the disciplinary committees are not needed.

Third, exchanges are required to establish and to enforce rules that minimize conflicts of interest in the decision-making process. There is a flexibility for each exchange to determine how to meet this requirement, recognizing that each exchange has a different governing structure. At NYBOT, we disqualify board members from participating in a decision if they have potential conflicts. However, if a person with a potential conflict has a useful expertise, we may ask that that person provide information to the board to inform our deliberations.

In closing, on behalf of the exchange, its trading community, and users, I would like to thank the CFTC, this committee, and the Congress for the support they gave NYBOT after 9/11. NYBOT was the only exchange completely destroyed in the World Trade Center terrorist attack. Fortunately, we had a backup trading floor facility in Long Island City, and using this site, we opened up 6 days later. Thanks to the assistance Congress provided, we were able to rebuild in lower Manhattan and move into our new facilities in September of 2003. In 2004, we hit a record trading volume of approximately 32 million contracts, representing a 32 percent increase over the 2003 volume.

Mr. Chairman, I would be happy to answer any questions you or the committee members may have. Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Schoenhut can be found in the appendix on page 82.]

The CHAIRMAN. Mr. Nandapurkar.

STATEMENT OF SATISH NANDAPURKAR, CHIEF EXECUTIVE OFFICER, EUREX US, CHICAGO, ILLINOIS

Mr. NANDAPURKAR. Thank you. Chairman Chambliss, Senator Lugar, thank you for the opportunity to testify. I am Satish Nandapurkar, CEO of Eurex US. Eurex US is grateful today to be invited to participate in these hearings and to be able to present our views as a relative new entrant in these markets.

I am in agreement with the others on this panel that, in our opinion, the CFMA has been a tremendous success. It is working

as Congress intended, namely by giving exchanges more freedom to innovate and by making it more attractive to operate in the U.S. as a U.S. registered and regulated futures exchange.

The CFMA has facilitated an unprecedented level of competition in the United States, resulting in greater innovation, greater efficiency, and greater choice for market participants. The numbers speak for themselves. In 2000, total volume on U.S. futures exchanges was 600 million contracts. Last year, total volume ballooned to 1.6 billion.

We are also of the opinion that the CFTC has done an outstanding job in putting into practice this groundbreaking legislation, starting with former Chairman Newsome and now continuing with Acting Chairman Brown-Hruska. The CFTC has moved expeditiously, yet prudently, in implementing the new streamlined regulatory structure while ensuring that participants are adequately protected.

Since enactment of the CFMA, the CFTC has designated eight new futures markets and eight new clearinghouses. Not surprisingly, the increase in competition has been accompanied by new products, new services, lower costs, and increased efficiency. Six hundred new products have been filed since enactment of the CFTC, and as exchanges compete, fees drop, and sometimes dramatically. When we came into the market for Treasury futures products, the incumbent exchange, the CBOT, dropped their fees 80 percent, in some cases dropped their fees to zero. That resulted in substantial savings for end users.

Competition has also forced exchanges to finally respond to customers' preferences for the transparency, immediacy, and efficiency of electronic trading. The majority of futures traded in the United States are now traded electronic. That was certainly not the case in 2000. Thanks to electronic trading, a trader in Georgia or a trader in Indiana has the access to the same information, is on the same playing field that was once reserved for exchange members that stood in the pits in Chicago.

We at Eurex US are particularly indebted to the committee, for without the committee and without the CFMA, there would be no Eurex US. If I may, I would like to tell you a little bit about my exchange.

We are a new futures exchange registered with the CFTC and regulated fully by the CFTC. We are headquartered in Chicago with a U.S. management team based in Chicago. Our clearing is handled by the Clearing Corporation, a 70–year-plus institution based in Chicago. All our market surveillance and trade practice surveillance is provided by the not-for-profit National Futures Association, also based in Chicago.

We launched last February with futures and options on two-, five-, 10-year Treasury Notes and 30-year Treasury Bonds. We have expanded our product line this year to include equity indexed products, namely the Russell 1000 and 2000 futures.

Our approach to derivative markets is quite straightforward. We believe that all customers should get the benefit of a fully electronic trading system, equal access to information on a level playing field, and low fees for everyone. We believe that no one should have to pay for a membership to be able to get these benefits.

Our goal here is not just to compete in the United States, but to expand the market in doing so. As markets continue to globalize, we plan to be on the forefront of facilitating cross-border trade, making it easier for European participants to access U.S. markets and U.S. participants to access European markets. We have had extensive discussions with the CFTC on the implementation of the next phases of our global business plans.

In enacting the CFMA, Congress placed great faith in competition and that faith has been rewarded. Greater innovation and greater efficiency has been the engine of growth in the futures industry over the past few years. In our way, we are trying to realize the potential created by the CFMA. We offer the U.S. marketplace open and equal access, an all-electronic venue, competitive trading in existing products, new products, and low fees for everyone. Our course forward is to build on this foundation, to bring greater business into the United States.

The CFMA has greatly facilitated our ability to do this. We urge Congress to stay the course. You have done your part. Now it is our turn to do our part. Continued reliance on the benefits of competition will transform this industry even further for the benefit of everyone and preserve the U.S.'s leadership role in the global futures markets. Thank you.

The CHAIRMAN. Thank you, Mr. Nandapurkar.

[The prepared statement of Mr. Nandapurkar can be found in the appendix on page 88.]

The CHAIRMAN. Mr. Damgard.

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, DC

Mr. DAMGARD. Thank you very much, Chairman Chambliss, Senator Lugar. I am pleased to appear with my friends from the exchange community. On behalf of the Futures Industry Association, I want to thank you very much for appearing here today.

I have one advantage over the others at the table, if it is an advantage, and that is that I have been involved in every CFTC reauthorization since the agency was created in 1974. I remember well, Senator Lugar, those discussions in 1978 at the first reauthorization. Along with Leo Melomed, who is here and needs no introduction, we were the only ones that go back quite that far.

I know firsthand the historic and vital role this committee has played in periodically reviewing the CFTC's operations and reforming the Commodity Exchange Act when warranted. This committee's work on the Commodity Futures Modernization Act of 2000 is only the latest example of your significant contribution to our mutual goals of strong, competitive, innovative, and honest futures and options markets. Your longstanding commitment is greatly appreciated by this industry.

In light of that expertise, we would make a specific recommendation to this committee. As you know, last year's energy bill contained amendments to the Commodity Exchange Act. If similar efforts to amend the Act are made this year, we believe they should be part of this committee's consideration of CFTC reauthorization instead of in the energy bill.

The CFMA was a piece of landmark legislation which left the Commission with a very ambitious agenda. Under strong leadership, the Commission has implemented the new regulatory design authored by this committee. They are to be commended for their efforts.

CFTC reauthorization provides an opportunity to reconsider the regulatory program for the futures markets to see what is working and what is not. In FIA's view, the list of what is working is long and the list of what is not is quite short. My written testimony goes over those lists in more detail, but let me just summarize some of the high points.

The fundamental changes enacted in the CFMA have worked well. We are not in favor of any change to the basic statutory design. In particular, FIA would be concerned with any plan to expand dramatically the jurisdiction of the CFTC. In our view, when the CFTC's mission strays from its oversight of exchange traded futures and options, it distracts from the Commission's ability to achieve the Act's essential regulatory purposes.

That is why we have concerns about any proposal to expand the CFTC's jurisdiction as a response to the ongoing problem of fraud against retail customers in OTC FX transactions. The CFTC was not set up to become a national consumer protection agency for commodity transactions, a fact that this committee recognized in 1982 when it wrote, quote, "The Commission by itself cannot be primarily responsible for policing every enterprise operating under a commodity theme."

Consistent with this committee's reasoning, our approach to retail FX fraud would be twofold. First, give the CFTC specific targeted authority to pursue fraud claims against otherwise unregulated persons, and second, encourage law enforcement officials to take action against, and if need be, put behind bars, those who con retail customers in FX transactions. The only proven way to deter and end retail FX fraud is a strong, cooperative, Federal, State, and local law enforcement campaign to lock up those responsible and keep them from bouncing from one jurisdiction to another when they get caught.

Fair competition, transparency in exchange rulemaking, and true SRO independence continue to be areas where the FIA would support improvements. The CFMA has sparked efforts to introduce more direct competition among exchanges, as we had hoped. Thus far, the challenger markets have not been successful in doing more than chipping away at the entrenched markets' dominance. Further action by Congress and/or the Commission may be needed to accomplish the real purpose and the real promise of competition by affording our customers a choice of efficient, low-cost market platforms from which to select the best price available for any trade.

No one wants to go back to the days when all exchange rules required costly and time consuming CFTC approval. Our concern is that the current regime works to shut out our members and their customers from both the exchange internal approval process and any subsequent CFTC review. For example, a 3-day private comment period on whether the Commission should approve an important exchange rule is no substitute for the kind of due process anyone would expect from a fully informed agency deliberation. We

look forward to working with this committee, the Commission, and the exchanges to make exchange rule makings more open to public comment and input.

SROs have an important job to do, making sure that the public has confidence in our markets. Independent directors signal to market users around the world that our SROs are serious about self-policing and put the public interest above their business interest. While some exchanges, notably the Chicago Mercantile Exchange, have made real strides in this area, others have not. We want to work with all interested parties to strengthen this aspect of SRO operations.

Our last concern is product availability. Our members serve a sophisticated customer base that use futures markets all over the world to manage price risks in their business or investment activity. When U.S. law or regulation prevents our customers from obtaining access to exchange-traded products either in this country or overseas, it has the perverse effect of forcing our customers to use other less transparently priced instruments to manage those risks, often without the clearing protection exchange trading affords. While those anomalies do not occur often, where they do, we ask this committee's help in removing them.

In conclusion, Mr. Chairman, FIA looks forward to working with this committee and its staff and the rest of the industry. We believe that with a handful of changes, we can make an excellent regulatory system even better. Thank you very much, and I am pleased to answer any questions.

The CHAIRMAN. Thank you, Mr. Damgard.

[The prepared statement of Mr. Damgard can be found in the appendix on page 93.]

The CHAIRMAN. Let me just say to all of you, as we did with the Chairman of CFTC, we would like to request that you give us any recommendations for proposed changes that you might have in writing so that all members of the committee can review any suggestions that you have as we move forward with this reauthorization.

Mr. Nandapurkar, your testimony mentions the proposed Global Clearing Link. Could you explain in a little more detail what this is, how it works, and its effect—what effects it might have on the markets?

Mr. NANDAPURKAR. Mr. Chairman, I would be glad to. The Global Clearing Link is a mechanism that links our clearinghouse, the Clearing Corp. in Chicago, with the clearinghouse of Eurex in Frankfort, Eurex Clearing. We believe it is similar to other clearing arrangements that have been in place before, namely the CME link with Singapore, their MOS link, and the CME link with MEFF. We are trying to provide benefits to members and benefits to customers where we can lower their costs and provide greater efficiencies in them doing cross-border trades.

We have already gotten phase one of the Global Clearing Link approved, and in phase one of the Global Clearing Link, the real benefit is that it allows U.S. customers to repatriate their funds from overseas back into the U.S. What happens today when people trade or when traders trade, they can trade all over the world, as

Mr. Damgard just said. There are traders here in the U.S. that trade in Europe. There are traders in Europe that trade in the U.S.

For Eurex, about 20 percent of Eurex's business comes from the U.S., and when a trader in the U.S. trades on Eurex, they trade on the exchange, they leave their funds at Eurex Clearing, and that is where they put their margin. Thanks to the first phase of the Global Clearing Link and the link between the Clearing Corp. and Eurex Clearing, now those same U.S. traders can repatriate their funds out of Europe and back into the U.S. and hold their margins and hold their positions back with their clearing firm here in the United States. We can get the money out of Europe and back here and it gives them the opportunity to do that with their U.S. relationship.

The second phase of the Clearing Link is a phase where new European customers—what we hope we can do with the second phase is to allow a new set of market users in Europe, namely small and mid-sized European customers, to have better access to U.S. products. What we are going to hope to allow them to do is to trade U.S. products, but use their existing clearing relationships in Europe to be able to clear those products. By doing that, we hope to bring a lot of new business into the U.S., and that is probably the biggest benefit, is the type of business that we are going to get and the new business that is going to come in.

We are working with the CFTC. We have had extensive discussions with the CFTC. One of the things I should mention is we have committed in our exchange application and our approval that we will not go forward with the Global Clearing Link in any way without full approval of the CFTC of that Global Clearing Link. We expect to be filing how we plan to do this fairly soon and we also expect that there will be a public comment period in terms of the details of the Global Clearing Link.

The CHAIRMAN. Mr. Carey, in your written testimony, you seem to have some concerns relative to the Global Clearing Link. Do you care to comment?

Mr. CAREY. Yes. Thank you, Mr. Chairman. We believe if they go forward, the Frankfurt Clearing House should register as a DCO. It is the best way to ensure consistent protection for U.S. customers. We haven't seen the application for the Link itself, so we are not sure how it is going to function.

The CHAIRMAN. Mr. Duffy, in his written testimony, and Mr. Damgard referred to it somewhat, the FIA appears to raise some concerns of possible problems with regard to the SRO structures of the exchanges that may create conflicts of interest for the exchanges and allow them to impose rules which benefit themselves but have anti-competitive consequences for competing exchanges and the users of exchanges. Would you care to give me your response to this concern, please, sir?

Mr. DUFFY. Well, the Chicago Mercantile Exchange today has rules on its book that have been approved by the CFTC for many years and we just are upholding all of our rules to make sure that the centralized marketplace is not fractured. What we are doing is making certain that wash trades, which already are prohibited trades under the Commission's rules, don't happen at our institution. I believe that is what Mr. Damgard is referring to.

The CHAIRMAN. Mr. Damgard, any comment you wish to make?

Mr. DAMGARD. We have watched carefully what has gone on in the securities industry and we are certainly not sold on the idea that the New York Stock Exchange has the right model, where 100 percent of the directors have to be independent. Our members believe that at least 50 percent of the members of a board ought to be independent directors, and that leaves plenty of people left on their board who would have industry knowledge. It comes down to a definition of what is independent.

We would argue that floor traders subject to the regulatory authority of their SRO's, who can be disciplined, by those SRO's, do not qualify as independent. To say otherwise, simply doesn't meet the laugh test. The Chicago exchanges have had many, many qualified independent directors, such as Dan Glickman and Myron Scholes. Floor traders who historically looked out only for the interest of the floor, should not qualify as independent. In the old days, when there was no competition among the exchanges, the floor traders didn't really have to be concerned about what the customer thought because there was only one place to go with the trade. I believe such a policy of drawing independent directions from the ranks of the floor trading population would hurt the reputation of our industry. We need to make sure that customer confidence in these exchanges remains very, very high.

Mr. DUFFY. Mr. Chairman, if I may respond, I thought you were referring to some rules that we have enforced at our institution. As far as the independence issue related to the governance of the SRO, the Chicago Mercantile Exchange is a publicly traded entity and our board and all of its members do comply with the listing standards of the New York Stock Exchange and the SEC. We have an independent board, which we are required to have by law, with a majority made up of independent directors. We do comply with all NYSE and all SEC requirements as far as our independence.

Mr. DAMGARD. I would only respond by saying the New York Stock Exchange does not consider local market makers as independent.

The CHAIRMAN. Mr. Schoenhut, what are your views of the current structure of CFTC oversight of exchange governing bodies and disciplinary committees?

Mr. SCHOENHUT. Thank you, Mr. Chairman, for that question. NYBOT is quite satisfied with the CFTC oversight functionality. In our experience with the CFTC with respect to our board, I should point out that we have five independent or public directors and then people of expertise from several trade areas, futures commission merchants both large and small, as well as floor traders comprising the balance of our board. We feel that this system has worked successfully for years, as is evidenced by the fact that the New York Board of Trade has received many favorable commentaries by the CFTC. We feel that our board and the issues that come to our board at times can be very technical in nature, and to have expertises such as what we have is very important to our business.

The CHAIRMAN. Thank you. Senator Lugar.

Senator LUGAR. Mr. Chairman, in carrying on a little further this current inquiry, certainly, an enormous amount has been written

in the financial press about boards of directors. Both Fortune and Business Week, as I recall, in recent issues have surveyed Sarbanes-Oxley and what it has meant to many corporations, and still, a minority of New York Stock Exchange listed stocks seem to have something that appears to meet the standards of Sarbanes-Oxley, although there are a good number of rationalizations why this is not so.

It is important, and each one of you have said it in your own way, that this industry really exemplify confidence levels with regards to the directors. This is a serious issue, but a difficult political issue within each company, or maybe even within each exchange. Really, it is beyond our—well, we are not going to get into it exchange by exchange today as to what these circumstances have been and how reforms have been made, but I would just say that at a time when things are moving well, and each of you are testifying that way and we feel that way, this is a time to make certain we are in consonance with the general business community, and it is still one of reform. A good number of corporations in America, not hopefully any here today, are resisting that reform. They are hoping it will blow over as an enthusiasm that came after the stock market bubble and what have you.

I am hopeful that you will work with us as we try to boost you. This is not a mutual admiration society, but nevertheless, this committee has taken a strong interest in the strengthening of the industry and in ensuring people of the integrity of it, both at home and abroad, and so have you. I simply see something here that is important to maybe examine more carefully. I really have not, and so I am intrigued, really, by the discussion.

Let me just ask you, Dr. Newsome, because you have seen historical memory from your own standpoint as Chairman, why do you believe the volume of transactions has risen so dramatically on some of the exchanges that have been testifying here today? What is happening in our economy or in the world or maybe in the structure of these markets and trading practices that would lead to that kind of dynamic increase?

Mr. NEWSOME. Thank you, Senator Lugar. I would respond in a couple of ways. One goes directly to the flexibility afforded by the Commodity Futures Modernization Act and that leads to part of the discussion we are having here about corporate structure.

Senator LUGAR. Yes.

Mr. NEWSOME. One of the things that the Act did that was most important from this committee and the Congress was to allow the exchanges to all get outside of the box that they were required to serve in prior to the passage of the CFMA. With that new flexibility, we have seen exchanges go in different directions in terms of the types of products they offer, the types of services that they offer to their members and to their customers, and differences in corporate governance structure, as well. We all have rules and regulations, some just by the CFTC, others, as NYMEX and the CME, with regard to the SEC. Even though we are not a publicly traded company, we are an SEC registered company and have to abide by all of the Sarbanes-Oxley rules, which we have implemented over the past year.

While there certainly are some constants, the flexibility to come up with differing products and differing services to customers was certainly a key component of this increase in volume. I don't think it is a coincidence that it all happened at the same time.

The second component of that, I believe, is really a maturing of the futures industry. If you look at futures on agricultural products, obviously, that goes back many, many years. Over the last 25 years, there has been an explosion in the development of new products within the futures industry to allow customers in other service areas to manage their risk, from the financial products very successfully offered by both the Chicago exchanges to the energy contracts that NYMEX and other products in all the exchanges.

Customers, end users, have developed more and more comfort with how to utilize these products to manage risk. As the banks have expanded, as the companies, the underlying producers or processors of these products have matured and developed more of a comfort level, they have realized the opportunities to utilize futures products to manage risk and therefore, the explosion that we have seen over the last few years.

Senator LUGAR. No one could——

Mr. DAMGARD. May I add a word?

Senator LUGAR. Yes, Mr. Damgard.

Mr. DAMGARD. I also think it is competition. The competition has caused the existing exchanges to reduce their fees. We all knew that they knew how to compete, and they certainly have done so. The explosion in volume is clearly a result of more and more people utilizing these risk management devices. There is no question in my mind but what, even though it was resisted by some 4 years ago, this committee deserves an awful lot of credit for making sure that competition now exists in our markets.

Senator LUGAR. I appreciate that comment, especially from the standpoint of farmers in the country. The committee maybe is an improbable committee to be regulating all of this, although it grew from our interest in the agriculture commodities some time ago. The same principles have worked, as you all have illustrated, for a lot of different situations, different markets.

One of the problems of testimony of farmers and farm groups over the years has been how few farmers either understood these markets and their importance, and sadly, how few really took advantage of those opportunities. It appears to me that there probably is a greater participation by people in the agriculture community, producers, in these markets. In part, we have had long discussions of crop insurance at various levels, tried to think through with farmers who, at a typical meeting, say in my State would have said, we plant the crop, we harvest the crop and take the price that you get. God willing, we survive.

Unfortunately, this kind of faith did not lead to survival. The need to have crop insurance against catastrophe, but even more, to be thinking in terms of forward contracts, to be making some disciplined sales, is all the difference in a very low-margin business, and for many farmers, the only difference between a loss that is very severe and the possibilities of staying alive.

The educational process still is an important one, and although many of the farmers now are larger, perhaps, a lot of younger

farmers have come along who do not see what you are doing today as gambling, and that used to be the charge, that you folks are simply countenancing almost a vast casino situation, many younger farmers coming through their own educational process financially have seen the value and, in fact, the importance of what is occurring here, quite apart from all sorts of other users in industry or other people throughout the world may see this, and I hope that will continue.

It may be a small part of the picture in terms of volume as we now look at what was surveyed today, but it is very important to this committee. It is very important to our country that our farmers be successful and that they have these opportunities, they have confidence in these markets. To the extent that you have enhanced that, we really appreciate it very much.

Mr. Chairman, I would just ask a final request that I put a short opening statement I had that I did not deliver in the record. I appreciate your indulgence in that.

The CHAIRMAN. Certainly. Without objection, that will be done.

Senator LUGAR. Thank you, sir.

The CHAIRMAN. You are absolutely right. Mr. Damgard made a very good point, that it is critically important that the integrity of the markets be maintained. Otherwise, that confidence will not be there. While you might still be somewhat identified as solely a part of the agriculture community, we know otherwise. The agriculture part of it is so vitally important. You don't find a successful farmer today who doesn't have a computer sitting on his desk, and they utilize those computers on a daily basis to bring up the markets relative to their particular products that each of you deal with.

Dr. Newsome, in your testimony, you made reference to a new NYMEX study of hedge fund participation in NYMEX natural gas and crude oil futures markets. Would you very quickly summarize that study's findings for us, please?

Mr. NEWSOME. Yes, sir, Mr. Chairman. Not long after coming to NYMEX, we experienced some pretty drastic volatility in energy markets. The press and many others were quick to point the finger at speculators, particularly hedge funds and their involvement in the markets. As an exchange with access to the actual data of who was trading, I felt that it was very important for us to look at that data and actually analyze the role of hedge funds with regard to some of our key markets because no one else had that data, and even though we had it, we didn't know the answer to the question.

In the beginning of August, we undertook a study. We actually expanded that study a couple of times to include the whole year from January through December of 2004, specifically looking at the level of activity of hedge funds in natural gas and crude oil contracts in NYMEX.

The findings would be somewhat surprising to a number of people, particularly the low level of activity in hedge funds in those two markets. With regard to the crude oil market, hedge fund trading was less than 3 percent. In crude oil, hedge fund trading was just a hair over 9 percent. Those indicate relatively low levels of trading activity, certainly from our standpoint, not large enough levels of trading in which they could potentially move the marketplace.

The second thing that we found is that the open interest in both of those contracts by hedge funds was quite a bit larger than most market participants, indicating that hedge funds tend to hold on to their positions for a longer period of time as regard to other market participants, therefore actually decreasing volatility because of holding onto those positions.

We go into detail, Mr. Chairman, in terms of that report. The fact that we are making it available to this committee today as part of the record is actually the first time that anyone has seen that report, as we just finished it. I am sure that as you read it, there may be other questions that arise and certainly we look forward to working with you to explain our findings in the report.

The CHAIRMAN. Thank you very much.

Let me say to each of you, as well as to Chairman Brown-Hruska, we appreciate your being here to give us your views on where we are with respect to the reauthorization of CFTC and what changes we should consider relative to the CFMA. Again, I will just ask each of you to give us in writing any suggested changes and your reasoning therefore. We will look forward to continuing a dialog with you.

It is truly amazing to sit on the outside of your markets and see the true growth and the competition. You are right, Mr. Damgard, has probably expanded this, but the sophistication of the investor because of the education of your particular institutions has contributed greatly to that, also. We appreciate your continuing work with this committee as well as your continuing cooperation with the CFTC.

We will leave the record open for an additional 5 days for written questions to be submitted to any of you and we would hope that you would immediately get those responses back to us.

We have another hearing set on Thursday, after which we will begin our deliberations as to what direction we are heading.

Again, gentlemen, thank you very much, and this hearing is concluded.

[Whereupon, at 12:22 p.m., the committee was adjourned.]

APPENDIX

March 8, 2005

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(202) 224-3254
Contact: Matt Hartwig

Statement of Senator Tom Harkin (D-IA)
Senate Agriculture Nutrition and Forestry Committee Hearing
Reviewing Reauthorization of the Commodity Futures Trading Commission
March 08, 2005

"Thank you, Mr. Chairman. In the four years since passage of the Commodity Futures Modernization Act (CFMA), the futures and derivatives industry has seen record volumes and unprecedented competition leading to new products and lower costs for users of these markets.

"I would like to welcome Chairman Sharon Brown-Hruska, Commissioner Walt Lukken, and our two newest Commissioners, Mike Dunn and Fred Hatfield. Mike is from Keokuk, Iowa and has a long record of service to agriculture. I am delighted to see him at the Commission. I look forward to working with all of you on reauthorization of the Commodity Exchange Act.

"I commend you, Chairman Brown-Hruska, for the CFTC's work in implementing and enforcing the CFMA. The CFMA addressed some critical issues facing the futures and derivatives industry in the 1990s. Congress sought to improve the competitive footing of the U.S. futures and derivatives industry by reducing regulatory burdens, clarifying the legal status of over-the-counter derivatives transactions, and reforming the Shad-Johnson accord to allow trading of securities futures.

"The CFMA has been largely successful in achieving these objectives. However, there are a few areas, noted in several witnesses' testimony and my own observations, meriting special consideration as we begin working on reauthorization of the Commodity Exchange Act (CEA) this year.

"This country has been rocked by several serious financial scandals the past few years. These scandals have shown that perhaps no segment of the futures and derivatives markets are safe from manipulation. Additionally, with the large expansion in futures and derivatives volume, we need to consider whether the CFTC needs additional tools to keep tabs on the over the counter trade in derivatives. Given the impact large pension funds, banks, and other financial institutions have on our economy, we should consider whether the CFTC should have the authority to ask for information from those institutions even regarding OTC activities—if it might help prevent a financial calamity down the road.

"I continue to be particularly concerned whether the CFTC has adequate authority to oversee energy markets. Energy swaps and derivatives have a far more direct linkage to consumer's pocket books than other exempt commodities such as metals. The 46 energy enforcement cases settled by the CFTC so far for over $300 million in fines demonstrates that the CFTC has the authority to punish

wrongdoing, and that the Commission is using that authority. Still, we need to make sure that Federal agencies have the authority and tools needed to detect and prevent these abuses from occurring in the first place—especially given the fallout they can have for consumers.

"We need to review the Commission's anti-fraud and anti-manipulation authorities, as well as its enforcement resources, to make sure they are up to the challenge of regulating existing markets. Particularly, I believe we need to consider whether anti-fraud and anti-manipulation authorities should be applied to principal-to-principal trades, such as those that take place on many electronic markets, as well as to brokered trades. It seems to me that all similar markets should be held to the same standards of transparency and openness.

"I thank you again, Mr. Chairman."

U.S. SENATOR PATRICK LEAHY

CONTACT: David Carle, 202-224-3693 VERMONT

Statement of Patrick Leahy
Commodity Futures Trading Commission Reauthorization

Mr. Chairman: The CFTC is one of the few commissions where I have worked with a majority of the Commissioners – since they are former hill staffers.

But first, let me commend Acting Chairman Sharon Brown-Hruska who has done a great job in her leadership role. I appreciate the fact that you have highlighted three areas of concern for us to consider during the reauthorization.

One of the three Commissioners – Mike Dunn – worked extensively with me on agricultural credit and banking issues when I became Chairman of this Committee in 1987. Mike did a great job for me, and for this Committee.

Commissioner Walt Lukken did a fantastic job for this Committee on the last reauthorization of the Commodity Exchange Act. He provided very thoughtful advice to this Committee – which was much appreciated.

Commissioner Fred Hatfield made major contributions to the Senate with his work for Senator Breaux, and helped me out more than once. And, one more, Doug Leslie was on loan to me and to Senator Lugar – from the CFTC -- for around two years to assist this Committee on these often complicated CFTC matters. I look forward to working with all of you, and with the excellent career staff at the CFTC.

First, I appreciate your efforts to close down some boiler-room operations which have bilked unsuspecting customers out of millions of dollars.

When families are desperate they can be lured into foreign exchange markets with phone calls and lies about making millions with only a small investment. Ruin awaits them. All of these illegal operations have to be shut down – permanently.

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In my role as ranking member on the Judiciary Committee, and as a member of the Appropriations Committee, I have steered some funding to the Justice Department for persons designated to work on specific issues – such as copyright and antitrust enforcement.

I want to work with you to see if that approach would help advance your efforts to prosecute these boiler-room fraud rings.

I also think additional educational efforts could help make consumers more aware of these scam artists.

Speaking of scam artists, I want to mention the Enron collapse. I remain very concerned about the energy markets – protecting the integrity of those markets is critical to addressing America's energy needs.

Because of the recent volatility in crude oil and natural gas markets, Congress needs to act regarding anti-fraud and anti-manipulation efforts.

I also think that the CFTC needs a stronger oversight role regarding over-the-counter foreign exchange and option contracts.

I understand this is a complicated issue because of the Seventh Circuit case -- *CFTC v. Zelener* -- and the *Next Financial* district court case in Florida -- but I want to work with this Committee, the CFTC, and interested parties on these, and other, issues.

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Testimony of
Sharon Brown-Hruska, Acting Chairman
Commodity Futures Trading Commission

Before the Agriculture, Nutrition and Forestry Committee,
U.S. Senate

March 8, 2005

Good morning Chairman Chambliss, Ranking Member Harkin and Members of the Committee. I am pleased to appear on behalf of the Commodity Futures Trading Commission (Commission or CFTC) to discuss the important issues surrounding the reauthorization of the Commission. Before I begin my testimony, I would like to recognize and introduce my fellow colleagues on the Commission, who join me here today. First is Commissioner Walt Lukken, who is certainly no stranger to many of you because of his years of experience working on the Hill. I had the pleasure of joining the Commission at the same time as Walt, and have greatly enjoyed working with him over the past two and a half years. As we proceed through the reauthorization process I look forward to drawing on his knowledge of the Commodity Exchange Act (Act).

I would also like to introduce the two newest members of the Commission—Commissioner Fred Hatfield and Commissioner Mike Dunn, both of whom I had the honor of swearing in this past December. In the short time that Commissioners Hatfield and Dunn have been at the Commission, they have contributed greatly to our efforts. I look forward to continuing to work with them and drawing on their considerable experience and insights. I have solicited input from all the Commissioners in preparing this testimony.

Finally, I would like to recognize and commend the staff of the CFTC. Having been on the staff of the agency during the early 1990's I was able to see firsthand the dedication they devote to the agency and industry they regulate. As the Acting Chairman I continue to see not only this dedication, but the enormous energy and creativity that they bring to their task. Without this energy and dedication, I am sure that much of the innovation that the Commodity Futures Modernization Act of 2000 (CFMA) enabled would not have been possible.

It was just over four years ago that Congress passed the CFMA. While this may seem like a short time, the amount of change that has occurred in the futures and derivatives industry over that period has been extraordinary. And much of that change has been facilitated by the flexibility and innovative foresight of that legislation. Today I would like to take the opportunity to brief you on the CFMA—the progress that the Commission has made in its implementation, what has worked well and what issues Congress may wish to consider during its deliberation on reauthorization this year.

Overall, the Act, as amended by the CFMA, functions exceptionally well. The CFMA has provided flexibility to the derivatives industry and legal certainty to much of the over-the-counter derivatives market. This flexibility has allowed the industry to innovate with respect to the design of contracts, the formation of trading platforms and the clearing of both on-exchange and off-exchange products. The industry is no longer overburdened with prescriptive legal

requirements and is able to operate using its best business judgment, rather than that of its regulator. At the same time, economic and financial integrity have been safeguarded and the Commission has been able to maintain its ability to take action against fraud and abuse in the markets it oversees.

Prior to the CFMA, the market was regulated with a one-size-fits-all model. It did not matter whether a customer was commercially sophisticated; whether the underlying commodity was susceptible to manipulation; whether a customer needed the flexibility of an over-the-counter contract or the liquidity of an exchange-traded one; or whether there was more than one way to deliver customer protections in the marketplace. This recognition by Congress of these differences represented a significant step forward in its design of the regulatory oversight structure. When Congress adopted the CFMA, it put in place a practical, principles-based model and gave the CFTC the tools to regulate markets that were challenged by competition brought about by technology and an increasingly global marketplace.

Since the passage of the CFMA, the futures industry has experienced phenomenal growth and innovation. Between 2000 and 2004, the volume of futures and options contracts traded on U.S exchanges has increased from 600 million contracts a year to over 1.6 billion contracts per year. The number of products traded on these exchanges has more than doubled from 266 to 556. Since enactment of the CFMA, eight new Designated Contract Markets have been approved by the CFTC, and 11 Exempt Commercial Markets and three Exempt Boards of Trade have filed notifications with the Commission.

The markets have also become more global. There is more access than ever for U.S customers wanting to trade on foreign exchanges as well as for foreign customers wanting to trade in U.S. markets. Last fall, the CFTC approved a clearing link with a European futures exchange that allows U.S. customers of the foreign exchange to carry these positions at a U.S. clearinghouse. In short, the CFMA has permitted a level of innovation in these markets not seen since futures contracts were first traded in Chicago during the 19th century.

One of the benefits that has come about from this innovation has been increased competition and the lowering of trading costs. In response to the U.S. Futures Exchange's (USFE) proposal to list competing contracts, the Chicago Board of Trade (CBOT) dramatically reduced its execution fees on its market. In addition, the CBOT reacted to USFE by offering, for the first time, contracts based on German securities that were previously traded exclusively in Europe on Eurex.

New product and rule amendment certification procedures in the CFMA have also lowered regulatory barriers and fostered innovation by providing exchanges greater flexibility in listing contracts and reacting to developments in the cash markets. One result of the lowered barriers to entry is that different contract designs, such as binary options, have been offered as alternatives to using traditional futures and options. In short, the innovation, competition, and customer choice envisioned by Congress in passing the CFMA is bearing fruit.

That said, we at the Commission are committed to ensuring that our regulatory policies are similarly responsive and that the implementation of the CFMA fulfils the intent of Congress.

Competition and innovation must be realized in such a way that customer protection is not compromised and that the financial and economic integrity of our markets is preserved. In that regard, there remains more that we can do as a regulatory agency--working with industry and other domestic and foreign regulators--to move the ball forward even within the current statutory model.

As we begin the reauthorization process, any change should come with careful consideration of potential outcomes, as well as any unintended consequences that may present themselves. The Commission and its staff stand ready to assist you in any and every way possible as you consider possible actions at this time.

With that in mind, let me highlight three areas of concern on which Congress may wish to focus as it deliberates during the reauthorization process. First, Congress may wish to evaluate whether clarifications are necessary for the legal framework provided for exempt markets. Second, Congress may wish to suggest ways that we can more effectively avoid duplicative burdens on the markets and, going forward, provide us with guidance and support as we seek to work with other agencies and jurisdictions. Finally, we at the Commission are cognizant of Congress's firm commitment to ensuring that customers are protected from fraud and manipulation and, to that end, Congress may wish to review whether the CFTC has clear and adequate authority to police retail fraud, particularly in the foreign exchange area.

Energy Markets

In the wake of the Enron collapse, and in response to recent run-ups in prices of natural gas and crude oil, there have been calls to increase the CFTC's regulatory authority in the energy sector. Some have called for retrenchment and a return to prescriptive forms of regulation like the adoptions of federally determined price limits and position limits. Others have called for more sweeping legislative changes that would give the Commission greater reach into proprietary and bilateral markets. As you consider the appropriateness of such proposals, I would ask that you keep in mind that the CFTC has responded decisively to prosecute wrongdoing in the energy markets.

The Commission has acted resolutely in the energy markets to preserve market integrity and protect market users, demonstrating that its authority is significant and that it intends to use it. I would note that the CFTC successfully pursued a complaint against Enron for manipulation of the natural gas markets, and subsequently attained a civil monetary penalty of $35 million. In addition, the Commission has filed and continues to pursue various actions and investigations in the energy sector against both companies and individuals. Our enforcement efforts thus far have resulted in the prosecution of 46 entities and individuals and the assessment of approximately $300 million in penalties. In addition, the CFTC has recently promulgated regulations clarifying and detailing its authority regarding exempt markets, including certain energy transactions, to better ensure that these markets remain free from manipulation and fraud.

We are aware that last year's energy bill contained several provisions that would have directly affected the CFTC's oversight responsibilities, and we believe that it is appropriate and timely for our authorizing committees in Congress to consider and weigh in on these proposed changes.

The proposed changes sought to make it clear that the Commission has the authority to bring anti-fraud actions in off-exchange principal-to-principal transactions, such as those that occurred in the Enron Online-type of environment. While the CFMA provided for the Commission's fraud authority over exempt markets, some have questioned whether its application to bilateral and multilateral transactions would hold up given that our fundamental fraud authority appears to pertain only to intermediated transactions. It has been the Commission's contention that Congress intended to give the Commission fraud authority under the CFMA. Nonetheless, Congress may wish to provide us with additional guidance regarding this area of the Act.

The energy bill also contained savings clauses to confirm the Commission's exclusive jurisdiction with respect to futures and options on energy commodities, a provision to reaffirm the Commission's civil authority, and a provision affirming that these changes restate existing law and continue to apply to acts or omissions that occurred prior to enactment. Since these provisions of the energy bill amount to clarifications, Congress may wish to consider the necessity of these changes and its intent regarding Commission jurisdiction.

Securities Futures Products

As you know, the CFMA was noteworthy, in part because of Congress's decision to permit the trading of futures on single securities, under the joint jurisdiction of the CFTC and the Securities and Exchange Commission (SEC). However, more than four years after the CFMA's passage, the growth of single-stock futures trading continues to be modest at best. In December 2004, the NQLX exchange, one of two exchanges that had been offering single stock futures, suspended trading.

It is of some concern that this sector has not been more successful and that despite the best efforts of the Commission, the CFTC and SEC have not fully achieved the goals of the CFMA. In particular, it is of concern that more progress has not been made with respect to implementing portfolio margining; that we have not avoided the double audit and review of notice registered exchanges and brokers; and that we have not determined the appropriate treatment of foreign security indices and foreign security futures products.

In many areas, however, I am pleased to say that the two agencies continue to work to establish regulatory approaches that avoid duplicative registration and regulation. Beginning in January, the staffs of the CFTC and SEC have been meeting to discuss a means whereby commodity pool operators, commodity trading advisors and hedge fund operators can be overseen without imposing duplicate regulatory structures. As we move forward, the agencies must take to heart Congress's instructions to avoid duplicative registration and regulatory requirements.

Retail Forex Fraud

The CFMA clarified that the CFTC has jurisdiction over retail foreign currency futures and option contracts, whether transacted on exchanges or over-the-counter as long as they are not otherwise regulated by another agency. However, as demonstrated in the recent adverse

Zelener[1] decision, a case litigated by the Commission, the CFTC continues to face challenges to its jurisdiction based on how retail forex transactions are characterized. In this case and others, defendants often argue that transactions allowing retail customers to speculate on price fluctuations in foreign currency are not futures contracts, but spot or forward transactions outside the Commission's jurisdiction, including its fraud authority.

We at the Commission have been and remain committed to protecting retail consumers against the kind of egregious fraud that we see in the forex area. It has been the subject of much discussion within the industry and among the derivatives bar as to how to respond to the *Zelener* decision--whether we need additional authority or clarity in our jurisdiction, or whether we simply need to prove up our cases better. I would point out that our overall track record in the forex area is favorable. Since the passage of the CFMA, the Commission, on behalf of more than 20,000 customers, has filed 70 cases and prosecuted 267 companies and individuals for illegal activity in forex. As a result of those efforts, we have thus far imposed over $240 million in penalties and restitution. Of the 70 cases that have been filed thus far, the Commission has lost only three.

Conclusion

As noted, it has only been just over four years since Congress enacted, and the Commission began implementing, the CFMA. Given the progress made and the lessons learned, Congress may determine that it is premature to open the Act to significant changes. The Commission has been able to effectively work within the current structure of the Act to police markets, to ensure the integrity of the price discovery mechanism, to maintain the financial integrity of the markets and to protect customers. Nonetheless, the Commission stands ready to offer its assistance as Congress moves through the reauthorization process and considers a range of potential options.

In conclusion, let me say that my fellow Commissioners and I welcome this opportunity to work with you on the reauthorization of the CFTC. I greatly appreciate the opportunity to testify before you today on this important matter and would be pleased to answer any questions that the Committee may have.

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[1] *See CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004), *reh'g and reh'g en banc denied by* 387 F.3d 724 (7th Cir. 2004).

TESTIMONY OF CHARLES P. CAREY

CHAIRMAN OF THE CHICAGO BOARD OF TRADE

BEFORE THE SENATE AGRICULTURE COMMITTEE

March 8, 2005

Mr. Chairman and Members of the Committee, my name is Charles Carey. I am Chairman of the Board of Trade of the City of Chicago. As the Committee begins considering the re-authorization of the Commodity Exchange Act, it is an honor for me to appear before you and to present the Board of Trade's views.

We commend this Committee and the Congress for passing the Commodity Futures Modernization Act (CFMA) and the Commodity Futures Trading Commission (CFTC) for its exemplary job in implementing the provisions of the CFMA. We in the futures industry are fortunate to have had Members of Congress and regulatory authorities who realize the importance of determining prices of goods and services through open, transparent competition between buyers and sellers reflecting the interplay of economic forces.

The Commodity Futures Modernization Act of 2000 provided much-needed regulatory relief to entities regulated by the Commodity Futures Trading Commission and granted the Commission flexibility to deal with new ideas and technological advances, while at the same time retaining concepts of customer protection that are essential to our industry. In addition, the CFMA brought legal certainty to many products either by removing them from Commission jurisdiction or by establishing standards and procedures by which products can be and remain exempt from further CFTC regulation. The CFMA also allowed for the trading of security futures products for the first time. All in all, this legislation and its implementation by the

Commission has been a clear success. While the industry has benefited greatly from the reforms of the CFMA, there continue to exist some areas of uncertainty, overlap and the risk of regulatory inconsistency that deserve discussion.

Regulatory Reform and Process

The CFMA established a system of core principles to guide regulated entities while maintaining CFTC oversight of compliance with those principles. The core principles system is a successful one that has provided U.S. futures market participants flexibility in managing business models and responding to competitive developments. Among other things, the CFTC has used the authority granted it under the CFMA to enhance the ability of self-regulating exchanges to govern themselves without undue interference by establishing procedures under which an exchange may put certain rules into effect without requiring prior approval by the Commission. This has relieved regulatory costs without losing the benefits of regulation. The CBOT supports self-certification, but would be more cautious in its application in two areas. First, new market entrants, for example, may have less experience in crafting rules that comply with all provisions of the Act, and we hope Commission staff will exercise care in reviewing such rules. The CBOT also believes that certain rules, such as those pertaining to non-competitive transactions like block trades, as well as those pertaining to incentive programs, should be evaluated very carefully since they have the potential to threaten market transparency and integrity. Especially in markets trading the same or similar contracts, such trade practice rules can have an impact well beyond just one exchange. In addition, some incentive programs that function as payment-for-order-flow have the potential to encourage wash trading or to cloud

brokers' fiduciary duties. Our entire industry has a vested interest in making sure rules of any exchange don't compromise the integrity of one or multiple market centers.

Legal Certainty and Fraud Jurisdiction

The CFMA eliminated the legal uncertainty that impacted over-the-counter derivatives transactions prior to its enactment. Today, there is a different kind of uncertainty affecting the industry - uncertainty related to the CFTC's jurisdiction over retail fraud. In a recent Federal court decision (CFTC v. Zelener), the Seventh Circuit ruled against the Commission and held that contracts that called for delivery of a commodity within two days were cash contracts not under the jurisdiction of the Commission, even though the contracts were typically "rolled over" and were leveraged through the use of margin. The contracts at issue in the case were nothing more than speculation in foreign exchange. The effect of the decision, however, cannot be limited to foreign exchange speculation. It provides a roadmap for unscrupulous persons to engage in over-the-counter contracts involving agricultural and other commodities, with no government supervision whatsoever, and entirely free of the anti-fraud jurisdiction of the CFTC.

The Chicago Board of Trade does not wish to see legitimate operators of electronic dealing systems forced to become Designated Contract Markets (DCMs) or be otherwise overly burdened with regulation. However, the potential future impact of this decision is a matter of concern across the futures industry.

Stock Futures Products

The CFMA ended the ban on single stock futures in the United States that had existed since 1982. Security futures, however, have yet to reach their potential. The CBOT, along with

the Chicago Mercantile Exchange and the Chicago Board Options Exchange, formed a joint venture – One Chicago – specifically to trade these products. However, exchanges, intermediaries and customers alike face difficulties arising out of the dual regulation of security futures by both the CFTC and the Securities and Exchange Commission. It is our hope that the collaborative process between the two agencies will become more productive and that the agencies will implement changes that may assist in making these products more viable. In particular, unfair and unnecessary margin inequities inhibit the growth of stock futures and their utility as hedging vehicles. Stock futures should be margined like other futures products if they are to have a chance to succeed.

There is also a technical issue arising from the definition of narrow-based security indexes. By not clearly distinguishing equity securities from other types of securities, this broad formulation may unintentionally capture indexes on fixed income securities, corporate bonds and other non-equity securities, suggesting some overlapping jurisdiction to the SEC on such indexes. This uncertainty inhibits contracts on indexes of such securities and deserves consideration at this time.

Issues Related to Cross-Border Business

One of the most clearly visible trends in the futures industry is that toward international expansion and cross-border business initiatives. One of the most notable developments on this front, of course, was Eurex's application in 2003 to establish a U.S. exchange. Short of establishing exchanges in other countries, exchanges from around the globe, including U.S. exchanges, regularly seek approval to offer their contracts to customers in other jurisdictions, and will continue to do so.

One of the novel cross-border initiatives currently under development is Eurex's plan for a "global clearing link." Essentially, the link is intended to allow customers to clear contracts traded on Eurex's German exchange at a U.S clearinghouse (Phase 1) and to clear contracts traded on Eurex's U.S. exchange at its German clearinghouse (Phase 2).

Phase 1 of the clearing link is currently operational. The Chicago Board of Trade believes that the structure of the Phase 1 link weakens protection of U.S. customer funds by allowing the co-mingling of funds held for customer business in U.S. futures products (segregated funds) with funds held for customer business on non-U.S. futures exchanges (secured amounts). The two separate regimes, segregated funds and secured amounts, were initially created by the CFTC due differences in international bankruptcy law that could cloud jurisdiction and dissemination of such funds in case of bankruptcy. The CBOT believes that the differences and uncertainty that caused the Commission to establish the two separate regimes still exists today, and we were disappointed to see that longstanding customer protection policy eroded in the context of the clearing link.

Phase 2 of the global clearing link would be designed to allow trades made on Eurex U.S. to be cleared at Eurex's German clearinghouse. Little has been made public at this point concerning how that might be structured. In late 2003, in a hearing before the House Agriculture Committee, the then-Chairman of the Commission stated that "[b]efore trades traded on a contract market in the U.S. could be cleared at a non-domestic [clearing house], we would require that the non-domestic clearing house come in and register as a designated clearing organization." The Chicago Board of Trade believes that to be good regulatory policy because it could lessen the potential for harm to U.S. customers.

It is our hope that when the Commission considers plans for this or other such cross-border arrangements, it will take the appropriate steps to ensure that all registration requirements are complied with and that the funds of U.S. customers continue to receive the same level of protection as they presently have on U.S. clearinghouses.

More broadly, as exchanges and firms across the globe look to do business in other jurisdictions, we urge the Congress and the Commission to keep in mind that the regulatory structures of other countries may not provide the same type or level of protections found in the United States. Other regulatory authorities may not have the same ready access to information that the Congress and the CFTC have found necessary to regulate markets and market participants efficiently.

The recent actions of a handful of traders in London selling and buying bonds through a European electronic trading system illustrate the potentially de-stabilizing effect that questionable market behavior can have across borders and between exchanges and marketplaces. Authorities and prosecutors in four countries are now investigating to determine whether there was price manipulation. This incident demonstrates the need for comparable regulation and information collection among international regulators.

In mid-February, the CFTC began discussions with the Committee of European Securities Regulators (CESR) to launch a "transatlantic cooperation initiative" the entities entered into last year. We hope that these discussions, as well as continuing bilateral talks, include not only efforts to lower unnecessary barriers to entry, but also issues of regulatory disparities and gaps that should be addressed as increased cross-border activity is contemplated.

The trend toward cross-border business presents special challenges for regulators at home and abroad. We are pleased that dialogue is taking place and urge extreme care in that exercise.

Decisions being made now with regard to policies and protocols for cross-border business are setting critically important and influential precedents that will impact the global derivatives industry for years to come. Just as it is incumbent on exchanges and other regulators of futures trading to be price-neutral in overseeing market participation, governments and authorities must take care that exchanges and electronic trading systems compete with each other under rules and procedures that do not confer competitive advantages that arise simply from different levels of regulation. The Congress explicitly recognized this by stating in Section 2 of the CFMA that one of the purposes of the CFMA was "to enhance the competitive position of United States financial institutions and financial markets."

The Chicago Board of Trade believes that international competition should be encouraged without yielding to regulatory imbalances which can endanger U.S. futures customers or establish competitive inequities. The Congress has built protections into the U.S. regulatory system which should not be disregarded or weakened in the name of global regulatory cooperation. Those customer protections are more necessary today than ever because of the increasingly global nature of derivatives markets.

Self-Regulatory System

The continuing success of the CBOT over the years is attributable in large part to our ability and willingness to provide a fair and open marketplace, where market participants of all sizes and types know that the prices of the commodities traded are arrived at in a transparent and competitive process. Market participants around the globe know and rely on our commitment to vigorous, even-handed self-regulation, enhanced by the oversight function of the Commodity Futures Trading Commission under the watchful eye of Congress and this Committee. This

long-standing model of private and government cooperation embedded within the Act remains vibrant.

The CBOT, like other U.S. futures exchanges, carries out a vigorous regulatory program over its members. We regulate ourselves, and discipline our members when necessary, because the Act and Commission regulations require it, because those who use our facility expect it and, most importantly, because it is the right thing to do. The Commission, through its Rule Enforcement Review Program periodically evaluates our regulatory programs and, from time to time makes suggestions for incremental improvement. Without fail, however, these Rule Enforcement Reviews have acknowledged the good job we have done in maintaining a superior self-regulatory system.

This regulatory cooperation has also allowed us to develop other cost-effective means of regulating the behavior of futures professionals and other market participants. Under the supervision of the CFTC, U.S. futures exchanges and the National Futures Association formed the Joint Audit Committee. Through the Joint Audit Committee, U.S. exchanges can fulfill many of their self-regulatory obligations while reducing duplicative audits and the resultant regulatory costs on firms that are members of more than one exchange. This is accomplished by allowing one Designated Self-Regulatory Organization to audit each member on behalf of all.

Some have speculated that the movement on the part of exchanges to for-profit status would lead to conflicts of interest between self regulatory obligations and economic self-interest. Nothing could be further from the truth. Any exchange, any business for that matter, recognizes the importance of being, and being perceived as, honorable and fair. The Chicago Board of Trade is, and will continue to be, dedicated to these principles. The Chicago Board of Trade is presently going through the process of becoming a for-profit organization. I assure the

Committee that this new status, while enabling us to compete more efficiently with other exchanges from around the globe, will not lessen our dedication to fair and forceful self-regulation.

Effective and credible exchange self-regulation requires the participation of persons who are knowledgeable about the sometimes arcane business of futures trading and who are dedicated to the well-being of the exchange and the participants who utilize its facilities. The Board of Directors and crucial committees must also contain a sufficient number of directors who are independent of the exchange, in other words, not materially affiliated with the exchange. The Chicago Board of Trade hopes and expects that regulators and others who are interested in the composition of self-regulatory organizations will keep in mind that independence of directors or committee members should not be subject to rigid standards or definitions that equate independence with a complete lack of knowledge concerning futures trading. For example, a member of an exchange who has no other material ties to the exchange should not automatically be excluded from the definition of "independent."

Conclusion

As the industry continues to evolve, and new challenges arise, regulatory flexibility may become even more important. Just as important, however, will be the preservation of proven elements of customer protection. The marketplace wants and deserves an appropriate level of safety and consistency of regulation.

The Chicago Board of Trade will respond to any questions the Committee or any Member may have and will provide any assistance you may deem necessary.

Thank you for this opportunity to appear before you.

Testimony of

Terrence Duffy,
Chairman of Chicago Mercantile Exchange Holdings, Inc.

Before the
Senate Committee on Agriculture, Nutrition and Forestry

March 8, 2005

I am Terry Duffy, Chairman of Chicago Mercantile Exchange Holdings, Inc., which owns and operates the largest U.S. futures exchange, and by many standards, the largest futures exchange in the world. Chairman Chambliss and ladies and gentlemen of the Committee, I am very pleased to participate in this important hearing regarding reauthorization of the Commodity Futures Trading Commission and its key statutory framework, the Commodity Futures Modernization Act of 2000 ("CFMA"). This timely hearing provides the Committee the opportunity to consider whether CFMA set a course for the industry that should continue or if the CEA is ripe for revision. To that end, my testimony first will summarize the enormously positive changes that CME has experienced since enactment of the CFMA and then will conclude with our recommendations on issues which warrant the Committee's attention in reauthorizing the CFTC this year.

I. OVERVIEW OF CFMA: HISTORIC AND SUCCESSFUL LEGISLATION

Throughout the 20th Century, and especially so during the past three decades, the CME has earned a reputation as a premier innovator and industry pacesetter in developing new products and trading opportunities. Given this heritage of innovation and being an exchange that was eager to bring its business model into the 21st Century, CME strongly believes that the CFMA has been an enormous success. As many of you who were deeply involved in the reauthorization effort five years ago may recall, the established exchanges supported legal certainty for OTC products and reduced barriers to entry of new exchanges in return for an elimination of prescriptive regulation and **freedom to innovate. And innovate we did**, predominantly in four areas: governance (including our role as a self-regulatory organization (SRO)); expansion of market penetration; innovation in product offerings; and pursuit of a legitimate entrepreneurial business model that is premised on meeting customer needs.

In the judgment of CME, the CFMA of 2000 represents successful landmark legislation that materially and beneficially reformed some of the nation's most important

financial markets. Specifically CME gained the right to demutualize and implement the form of governance necessary to complete a successful initial public offering (IPO) and to run a highly effective and efficient SRO. The scope and velocity of CME's expansion of its markets and product offerings has been unprecedented. CME's ability to expand its clearing services to other exchanges and to unregulated markets has been a boon to our customers and, as a consequence, to our bottom line.

U.S. futures markets are substantially stronger and more vibrant today as the direct result of Congress's enactment of the CFMA and, equally importantly, the CFTC's judicious and deliberate implementation of those reforms. Innovation has been encouraged and made less costly and more rewarding. The time between conception of a new product or trading system and its implementation has gone from years to days. Today, the vast majority of CME's investment in innovation is for products rather than paperwork and regulatory review. Our customers applaud CME's aggressive response to the CFMA's incentives for innovation and competition as evidenced by their enthusiastic response to our slate of products and services.

By illustration I would point out the following:

- Continuing the trend since the CFMA's enactment in late 2000, CME's average daily volume in February has increased more than 50% over the comparable period in 2004, when our average daily volume exceeded 3.8 million contracts, an all-time record.

- Electronic trading volume on CME® Globex® grew to more than 2.5 million contracts per day, representing 66% of total exchange volume in February.

- CME's Eurodollar futures contract remains the benchmark interest rate product around the world, commanding 97% of the daily trading volume. Average daily volume of CME Eurodollar futures on CME Globex in February exceeded 1.2 million contracts. This represented 77percent of total CME Eurodollar volume in February compared with 15 percent in February 2004.

- CME's FX markets hit an all-time volume record in February as average daily volume totaled more than 266,000 contracts, representing notional value of $35 billion per day and an increase of 49% from one year earlier. During the month, CME electronic foreign exchange products increased 83 percent from the same period one year ago to reach 210,000 contracts per day.

- Trading in CME E-mini™ equity index products averaged 1.1 million contracts per day in February, up 16 percent versus the same period last year.

- CME's commodity products also continue to trade well, with average daily volume in February at 43,000 contracts, up 35 percent from one year ago.

- Finally, the historic transaction processing agreement between CME and CBOT has delivered on its promise of efficiencies and $1.8 billion in capital cost savings to our joint members, setting new industry standards for responsiveness and efficiency.

II. CFMA HAS FOSTERED INNOVATION IN SELF-REGULATION

CME takes considerable pride in our status as the first demutualized and publicly-traded exchange in the United States. CME is currently the largest futures exchange in the United States and the largest derivatives clearing organization in the world. Moreover, our business has steadily migrated from the trading pits to our open access electronic trading platform---CME Globex. These changes have had a profound, positive impact on our financial performance, but as importantly on our customers' perception of our performance of our self regulatory responsibilities.

With our IPO, CME is now subjected to the stringent corporate governance standards and listing requirements imposed by the New York Stock Exchange, public disclosure of all material aspects of its business, and continuous scrutiny from savvy analysts and institutional investors. In order to meet our obligations and to instill confidence in our shareholders, CME's Board of Directors has transitioned to one that is both fiercely independent of management and well beyond the control of floor brokers and traders.[1] CME was the pioneer in including non-exchange members in its disciplinary processes and in insuring that its important standing Board Committees were led by and included significant representation of non-industry directors. The charters of all of these committees including the Market Regulatory Oversight Committee ("MROC"), which is composed entirely of non-industry directors and is directly responsible for the independence of the SRO function, are found at CME's website.

On April 30, 2004, CME became the first futures exchange to appoint a Board-level committee devoted to self-regulatory oversight. CME's MROC is comprised solely of independent, non-industry directors. As set forth in its charter, the MROC is charged with the following responsibilities:

- to review the scope of and make recommendations with respect to the responsibilities, budget and staffing of the Market Regulation Department and the Audit Department so that each department is able to fulfill its self-regulatory responsibilities;

[1] We also believe that directors who are members or end-users of an exchange organization have an invaluable understanding of the business and can provide useful perspectives on significant risks and competitive advantages. Indeed, the inclusion of exchange members on CME's Board has been beneficial in transforming CME from a century-old mutual organization to a thriving publicly-traded company and from a largely floor-based open outcry business to one of the largest electronic trading platforms in the world.

- to oversee the performance of the Market Regulation Department and Audit Department so that each department is able to implement its self-regulatory responsibilities independent of any improper interference or conflict of interest that may arise as a result of a member of CME serving on the Board or participating in the implementation of CME's self-regulatory functions;

- to review the annual performance evaluations and compensation determinations and any termination decisions made by senior management of CME with respect to the Managing Director, Regulatory Affairs, and the Director, Audit Department, so that such determinations or decisions are not designed to influence improperly the independent exercise of their self-regulatory responsibilities;

- to review CME's compliance with its self-regulatory responsibilities as prescribed by statute and the rules and regulations promulgated thereunder; and

- to review changes (or proposed changes, as appropriate) to Exchange rules to the extent that such rules are likely to impact significantly the self-regulatory functions of the Exchange.

We believe that the newly empowered MROC represents an aggressive and appropriate step towards independence in self-regulation.

III. CFMA HAS FOSTERED PRODUCT AND MARKET INNOVATION

We have all witnessed dramatic change in our industry during the last five years. CME has responded to these opportunities by successfully executing a growth strategy based on:

- Technology innovation;

- Continued product innovation;

- Expanding global distribution; and

- Leveraging the convergence of the cash, derivatives and over-the-counter (OTC) markets.

Technology Innovation:

In terms of technology innovation, we have redesigned our business model to leverage our electronic trading capability. A sign of our successful transformation is that

five years ago, CME had 125 people focused on technology. Today, we have over 400 talented technologists, reflecting our view of the future. CME Globex today significantly outperforms its competitors by facilitating trading around the world more than 23 hours a day, five days a week and with a 150 to 200 millisecond average turnaround time.

Technology innovation at CME has become equal in importance to product innovation. And our ability to innovate is multi-dimensional. It involves expanded user functionality and faster response times. It also involves increased reliability and the implementation of system features designed to enhance market integrity and protect customers from anomalous market conditions. Last January, we provided market users with the most sophisticated implied spreading functionality in the industry. As a result, CME Eurodollar futures on CME Globex went from 9.6 percent electronic in January 2004 to 75 percent last December.

A year ago, we acquired innovative patent-pending technology that now provides market users with a sophisticated electronic solution for complex options combination trading. CME is committed to preserving and enhancing transparency and competition among market makers in electronic options markets. Transparency and price competition are the hallmarks of CME's successful market model.

Another measure of our ability to innovate with technology is something most people never see. Over the last five years, and due to the unique processing demands of our enormously successful E-mini™ contracts, CME has built an extensive and highly scalable set of platforms and infrastructure. We now process over 600,000 match transactions daily, more than any other exchange in our industry. Part of our growth strategy is to offer processing services – and other collateral and risk management services – to other exchanges and trading platforms around the world.

Products:

Throughout the last 30 years, CME has been the leading product innovator in our industry, from financial futures in 1972, to cash settlement in 1981, stock index futures in 1982, CME Globex in 1987 and E-mini contracts in 1997. And in every case the world followed.

That leadership role has positioned CME with the most diverse and successful product line in our industry. Like technology, product innovation today at CME is becoming increasingly sophisticated. We work closely with market users to continually reassess product design, delivery system, trading conventions, pricing structure and other features that drive demand for our products.

This has fueled growth in each of our major product lines. For example, electronic trading of CME Eurodollar futures increased by 1,248 percent from 2003 to 2004. Our success is attributable to enhanced technology functionality, significant reductions in CME Eurodollar trading fees on CME Globex, and the implementation of our new CME Eurodollar market maker program – all of which has substantially enhanced liquidity on CME Globex.

Our popular E-mini stock index futures products also set a new record in 2004 with almost 265 million contracts traded, up 13 percent compared to 2003. Today, nearly 92 percent of trading activity in our equity products is electronic.

And these products have significantly outperformed other competing products, such as ETFs and equity index options.

Our foreign exchange product line has experienced nothing short of a renaissance in the last two years. Our electronic FX products have achieved a compound annual growth rate of 127 percent in average daily volume during the last two years. Volume growth in this product line is attributable to the speed of our CME Globex electronic trading system, our increasing distribution and our clearing house guarantee, as well as the declining value of the dollar.

Today, more than 80 percent of trading in our FX futures products occurs electronically. And, our FX product line has tremendous growth potential when one considers the nearly $2 trillion dollar a day turnover in global FX trading.

In addition to enhancing our existing core product lines, we will continue to innovate new products. Many of these new products will be more complex and highly structured products that meet the needs of more narrowly defined customer segments. While such products could not be easily or economically launched in the past, electronic trading enhances our opportunity for success.

Expanding Global Distribution:

CME has been working diligently over the last three years to dramatically expand global distribution and access to our GLOBEX system. We have done this by streamlining our application programming interfaces. In addition, we have introduced more flexible connectivity options, including user defined solutions which significantly reduce costs.

To expand the global distribution of our products, last year we installed telecommunications hubs in Dublin, Gibraltar, Frankfurt, Amsterdam, Paris and Milan, in addition to the one we installed in London in 2002. This growth initiative has been successful, allowing European customers to dramatically reduce their trans-Atlantic telecommunications costs. We plan to launch a similar hub in Singapore later this year.

In tandem with these technology enhancements and cost efficiencies, we put in place aggressive incentive pricing plans in both Europe and Asia to promote CME products and accessibility to CME Globex to new customers in those parts of the world.

The strong early response to this program suggests that we are succeeding in our strategy to bring new customers to CME who will find our products to be an attractive alternative to comparable euro-denominated products.

Another avenue of growth for us is to attract new distribution channel partners with the capacity to reach large numbers of nontraditional futures customers. We

increased access to our products through an agreement with Bloomberg which allows all 180,000 screens worldwide to access CME products on CME Globex. Additionally, as we continue to expand trading activity in our popular E-mini contracts, we are implementing connectivity agreements with E*TRADE and Schwab's CyberTrader. These new distribution channels allow us to reach the emerging professional equity retail sector who increasingly find E-mini contracts more attractive than cash equities, equity options and ETFs.

Most recently, we announced a growth initiative with Reuters, where we will be offering CME's electronic foreign exchange markets to Reuters' global customer base. This initiative marks the first major linkage of sell side traders in the interbank FX market to CME eFX futures markets, where hedge funds and other major buy side participants play a major role, paving the way for more dynamic and efficient markets.

Common Clearing Link:

Our transaction processing agreement with the Chicago Board of Trade (CBOT) is up, running successfully and producing even more synergies than any of us could have imagined. This common clearing link with CBOT is providing $1.8 billion in capital cost savings to our joint members.

IV. CME's RECOMMENDATIONS FOR REAUTHORIZATION

While CME enthusiastically applauds the success of the CFMA and recommends that we retain its historic statutory framework, the upcoming Congressional reauthorization process offers a valuable opportunity to fine tune that statutory framework based on industry experience garnered since the CFMA's enactment in 2000. In that regard, CME offers two recommendations for consideration:

Off-Exchange Retail Futures Trading:

The first area in need of fine tuning involves the jurisdictional issues regarding retail trading of futures-like products. In particular, over the past four years of the CFMA, the CFTC has brought 70 enforcement actions involving 267 companies and individuals for illegal retail foreign exchange trading. CFTC estimates that these cases involved trading with over 20,000 customers and resulted in imposition of over $240 million in penalties and restitution orders. The confluence of the massive continuing frauds committed against retail customers in the OTC foreign exchange ("FX") market, and the recent, unfortunate decision of the 7th Circuit Court of Appeals in CFTC v. Zelener, compel this industry to reexamine the public policy implications of how the CFMA addresses retail foreign exchange futures and the threshold definition of what transactions should be subject to CFTC jurisdiction.

The fact that the CFTC is compelled to devote such substantial resources to protecting retail customers from significant fraud is evidence enough that a serious problem exists with the CFMA that cries out for reform. Moreover, in the aftermath of

the Zelener decision, a retail product that most would agree is a futures contract--- but which has now been defined by the court to be a cash product---can be offered outside of the CFTC's jurisdiction. The sharp operators and bucket shops have already figured out that the rationale of the Zelener opinion can apply to commodities other than FX. How soon will it be before the CFTC's jurisdiction and its retail consumer protections are reduced to irrelevance?

At a minimum, we need an amendment that will preclude dealers from end-running CFTC's jurisdiction by simply inserting a one line caveat on their internet sites notifying counterparties that the dealer is not absolutely obligated to enter into an opposite, offsetting transaction or that under some circumstances an opposite transaction will not offset existing positions. The challenge for the futures industry---and this Committee--- is to find an effective solution that will politically survive the reauthorization process.

Security Futures Products:

The second area in which the CFMA needs to be modified is with regard to Single Stock Futures. In my Congressional testimony of June of 2003, I characterized single stock futures as "the CFMA's unfulfilled promise". I am sad to say what was true then remains so even today. As evidenced by their long-time successful use and acceptance in European markets, single stock futures can be a great product with enormous benefits to market users. However, inter-exchange competitive concerns combined with regulatory and legislative turf contests largely mitigated the hope for this product even before it was launched in this country. The regulatory system that has slowly evolved between CFTC and SEC has yet to address various key issues and several of the regulations that have been produced thus far are overly burdensome and inflexible, frustrating development of products that would be both useful and desirable to market participants.

It is time to let futures exchanges trade the product as a pure futures contract and to let securities exchanges trade it as a securities product. Let the relevant exchanges deal solely with their respective regulator, the CFTC or the SEC, which is what I believe the Congress intended in 2000 in authorizing single stock futures. We want competitive forces to determine the outcome—not government. Fulfilling that promise made in 2000 will advance the customers' interest substantially. We would encourage the Committee to use its oversight jurisdiction to insist that the respective regulatory agencies eliminate undue regulatory impediments that have been erected to frustrate the introduction of security futures products.

V. CONCLUSION:

The CME and its customers have prospered to the substantial benefit of the nation's economy under the CFMA. CME looks forward to engaging significantly in the upcoming reauthorization process and to achieving legislation that maintains the significant successes of the CFMA while making discreet corrections designed to materially improves the efficiency, competitiveness and fairness of our futures markets for our customers and all market participants.

Testimony of

Dr. James Newsome, President

New York Mercantile Exchange, Inc.

Before the Senate Committee on Agriculture, Nutrition, and Forestry

United States Senate

March 8, 2005

Mr. Chairman and members of the Committee, my name is Jim Newsome and I am the President of the New York Mercantile Exchange (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. We are a federally chartered marketplace, fully regulated by the CFTC. On behalf of the Exchange, its Board of Directors and members, I thank you and the members of the Committee for the opportunity to participate in today's hearing on the reauthorization of the CFTC.

The Commodity Exchange Act (CEA) as amended by the Commodity Futures Modernization Act of 2000 (CFMA or the Act) was truly a landmark piece of federal legislation that has provided critically needed legal certainty and regulatory streamlining and modernization to U.S. futures and derivatives markets. The legislative history preceding the passage of the CFMA was a long one that involved a lot of hard work and give and take on all sides. We commend this Committee for all of its efforts in achieving the passage of the final bill.

It is the view of NYMEX that the CEA, as amended by the CFMA, is by all indicators, providing a reasonable, workable, and effective oversight regime for the regulated exchanges.

The CFMA is providing a well-considered oversight framework that has enhanced the abilities of NYMEX and the other regulated exchanges to operate in a rapidly changing business environment and that has provided competitive benefits to the marketplace while continuing to ensure confidence in the integrity of our markets.

Prior to the CFMA, the CFTC operated under a "one size fits all" regulatory approach. Regulatory inequities imposed severe and unreasonable constraints on domestic exchanges competing with international and with unregulated exchanges operating in this country. In particular, prior approval requirements for rule and contract changes, especially where few or no substantive regulatory concerns were present, further exacerbated an uneven playing field and disadvantaged U.S. regulated markets.

The Committee and the Congress agreed that the orientation of the CFTC needed to be shifted to a more flexible oversight role. To address these issues, Congress established various market tiers so that a marketplace could now, in effect, select its appropriate level of regulation according to the product types offered, and more importantly, the participants eligible to trade on the facility.

As a result of the CFMA, NYMEX operates by choice at the highest level of regulation by CFTC under two regulatory categories for its distinct operations as a derivatives clearing organization (DCO) and as a designated contract market (DCM).

NYMEX offers both open outcry and electronic trading forums pursuant to the DCM regulatory tier. CFTC staff periodically undertakes reviews to assess the adequacy of self-regulatory programs and NYMEX has consistently been deemed by these staff reviews to have maintained adequate regulatory programs and oversight to comply with its obligations as a self-regulatory organization (SRO) under the CEA.

In addition to the creation of various new market tiers, Congress largely replaced extremely detailed, prescriptive regulation with more broadly worded "Core Principles" for regulated markets. The regulatory philosophy underpinning the use of these Core Principles is that Congress sets broad performance standards that must be met by the regulated entity, but then the entity will have flexibility with regard to how it complies with these standards.

The CFMA also made clear that regulated DCMs shall have reasonable discretion as to the manner in which they comply with the applicable Core Principles set forth in regulation. The Exchange's ability to respond to rapidly changing markets as needed by introducing market-oriented changes to contracts has broadly benefited market participants, by virtue of new risk management contracts offered to customers. Market participants have also benefited from recent levels of volume by all exchanges. As a result of Congress' foresight and innovation, such improvements can be implemented, subject to CFTC review and oversight, without protracted approval processes.

It is important to point out that, contrary to what some have suggested, the CFMA did not diminish the regulatory oversight responsibilities of the CFTC. Although regulated exchanges may self-certify new contracts and rule changes, CFTC retains the

responsibility to assure that all changes are in accordance the guidelines of the Act. In practice, there is always prior discussion with the regulator of any substantive change.

As contrasted with the rule submission process formerly in place, under the CFMA the regulated market can choose whether to self-certify to the CFTC that the rule change or new product complies with CEA and with CFTC regulations, or to request prior CFTC approval on a voluntary basis, or indeed to take both steps. We have utilized all three approaches. On a number of routine rule changes we have submitted self-certification filings. On some more novel changes we have voluntarily requested CFTC approval, and on a few occasions we have certified a rule change but also requested CFTC approval on a post-implementation basis.

While the broader marketplace may now understand that prior approval is no longer formally required by the CEA for exchange rule changes, what may be less understood is the extent to which NYMEX staff continues to consult with the relevant industry before proposing changes to our core products. We maintain a fairly extensive scheme of product advisory committees that generally include representation from all relevant sectors of the applicable energy or metals market. We have maintained these industry advisory committees for a number of years and we rely heavily on their informed views to assist us in weighing the merits of possible changes.

In addition, just as was the case in the pre-CFMA regulatory environment, NYMEX staff also continues to consult regularly with CFTC staff before formally submitting filings on significant rule changes. Depending on the nature of those consultations we may also submit rules informally in draft form even where we will eventually be filing the rule changes with the CFTC through the use of the self-

certification process. These discussions regarding proposed rule changes are one example of our broader commitment to maintaining strong lines of communication with our regulator.

Regulatory flexibility not only allows the regulated exchanges to remain competitive, but also produces better services and choices for the broad range of market participants seeking to reduce their exposure to risk.

Exchanges are meeting customer and industry demands more efficiently than ever using the ability to submit new products and rules to the CFTC on a self-certification basis, while adhering strictly to prescribed Core Principles. Innovation and fair competition are made possible by a business and operational model that is flexible and can adapt quickly to change.

Streamlining the product submission process has benefited our market users greatly by allowing NYMEX to bring new products to market and respond expeditiously to customers' market needs. Product innovations such as new platforms for trading and clearing futures have resulted from an enhanced ability to respond to constantly changing industry demands. This means that legitimate market participants benefit from more useful risk management tools, better use of technology, greater liquidity, more efficient pricing, and enhanced customer service. Regulatory flexibility for trading facilities has benefited all market participants by providing more alternatives in platforms, products and business models.

Although NYMEX is essentially a marketplace for commercial participants to hedge risk and discover prices on large volume transactions, the benefits to the marketplace also accrue more broadly to consumers who receive prices based on open and fair competition. The visible and highly competitive daily transactions in energy futures and options on the Exchange provide a true world reference price for the futures commodities traded, that is seen as a reliable global benchmark for energy pricing and that is vital to our economy.

NYMEX customers are largely market participants who prefer to conduct business in a fully and well-regulated marketplace where rules are applied consistently and where prices are transparent and openly disseminated. NYMEX operates under the CFMA's highest regulatory tier, where regulations are designed to safeguard market integrity and allow innovative competition as the driving market force.

Regulatory flexibility was critical in preventing additional corporate meltdowns in the credit risk crisis that followed the collapse of Enron, by enabling the Exchange to respond to the new risk management needs of the energy sector.

The failure of Enron set in motion a disruptive series of events throughout the merchant energy sector. The bankruptcy of such a large market participant raised valid concerns as to the financial strength of other energy firms and counterparty credit risk. In the aftermath of Enron's financial meltdown, other energy trading companies lost credit ratings, stock prices plummeted, and liquidity crises began to develop in these markets because parties lacked confidence in each other's abilities to perform transactions. Firms faced an urgent need for new mechanisms to address these credit issues.

NYMEX Compliance Staff, using established tools such as large trader reporting, position limits, and position reporting, alerted the Exchange to potential problems. Exercising its regulatory flexibility, the Exchange was able to address these issues by rapidly implementing a number of important measures, including the use of EFS (Exchange of Futures for Swaps) and EOO (Exchange of OTC Option for NYMEX Options), both of which are instruments to migrate positions from the over-the-counter (OTC) marketplace to NYMEX and to the protections provided by its clearinghouse.

NYMEX also launched over time an expanding slate of products appealing to OTC participants, which are executed off the Exchange, but brought to the NYMEX clearing mechanism. In so doing, 130 products that are traditionally traded OTC have been brought under the umbrella of a regulated exchange, which establishes the identity of participants, a transaction audit trail, daily position surveillance, and credit security.

Indeed, as the changes were enacted, a substantial number of market participants chose to transfer positions to NYMEX where their risk was mitigated by the protections offered by a federally regulated clearinghouse at which transparency, liquidity, and market oversight are paramount. In the early stages of Enron's difficulties in the fall of 2001, some observers feared that Enron's substantial position in the unregulated OTC marketplace could pose serious problems for a significant number of OTC market participants. In responding to the Enron financial crisis, CFTC utilized its flexible regulatory authority as intended in the statute to approve valuable service innovations while taking prudent steps to maximize systemic integrity. Upheavals in the energy sector following the collapse of Enron and revelations about illegitimate trades executed

on less regulated markets serve to underscore the importance of market transparency and a sensible approach to regulation.

The ability of DCOs to clear off-exchange transactions under the CFMA enabled NYMEX to initiate a new clearing service in May 2002. This service allows eligible contract participants to submit transactions in specified products to NYMEX for clearing. In this process as currently implemented at NYMEX, the off-Exchange contracts of market participants are replaced by futures positions to be maintained at the clearinghouse by their carrying Clearing Members, and are thus subject to the same protections afforded other futures contracts. NYMEX's demonstrated success in providing a reliable marketplace and credit security in a time of industry crisis underscores the advantages of doing business on a regulated marketplace to any business entity with credit or price exposure in these markets.

NYMEX's various regulatory safeguards allowed the Exchange to maintain solid footing during this challenging time. NYMEX not only operated safely during a volatile period, but thanks to the flexibility permitted under the CFMA, NYMEX was able to adapt its services expeditiously to provide this displaced market segment with the necessary tools to stabilize impacted businesses, mitigating and perhaps preventing additional credit disruptions.

Market integrity continues to be effectively safeguarded on the regulated exchanges through stringent adherence to the Core Principles set forth in the CFMA. In addition, NYMEX operations remain fully regulated and subject to review by the CFTC at every level.

Both NYMEX and CFTC have numerous enforcement tools at their disposal for use in overseeing markets and ensuring that trading conducted in a fair and orderly manner. As an SRO, NYMEX devotes significant resources to the oversight of all its markets as required by the CEA. As noted previously, CFTC staff routinely conducts rule enforcement reviews of our regulatory programs, the results of which are a matter of public record and are available on the CFTC's Web site. Our business model demands that the financial integrity of the marketplace take precedence over other business priorities. Layers of safeguards are imposed by the Exchange, and overseen daily by the CFTC, under our responsibilities as an SRO.

Our Compliance Department on a daily basis utilizes market oversight tools that include the following:

I) Large Trader Reporting

At the end of each trading day, NYMEX electronically collects from its clearing members and carrying brokers the identities of all participants who maintain open positions that exceed set reporting levels. This information is gathered and aggregated for all reportable participants in order to detect and identify market make-up and concentrations, to ensure compliance with expiration position limits and position accountability levels, and to administer hedge or swap exemptions.

II) Trade Register/Streetbook

NYMEX maintains a detailed and comprehensive audit trail of all transactions executed and cleared in its markets (both open outcry and electronic). Relevant

data, such as trade time, executing broker or electronic trader, customer type indicator code and the account number for the beneficial owner of the trade are collected for every executed trade in our markets. The transaction data can be reviewed by the Compliance Department with consideration for any criteria necessary.

NYMEX Compliance Staff routinely reviews trading activity on the Exchange's markets, with a general focus on ensuring compliance with intra-day expiration limits and hedge/swap exemptions, as well as activity during price moves in the market. To accomplish this, Compliance Staff use the Price Change Register to identify volatile periods in a given trading session and then analyze the activity within the Trade Register/Streetbook. Advanced electronic surveillance and analysis are used to identify activity that could indicate potentially disruptive trading by floor members, or by their ultimate customers. If specially trained Compliance Staff identify anomalies, a formal investigation is pursued and, if appropriate, formal disciplinary action will follow.

As an example, NYMEX Compliance Staff utilized these tools in December 2003 to conduct an in-depth examination of Natural Gas trading, and shared its findings with the CFTC. NYMEX did not find any coordinated or otherwise violative activity by any participants in our markets. I should note this market review included a focus on hedge funds, which have been a point of inquiry among members of this Committee. Similarly, the CFTC subsequently publicly released findings that no manipulation occurred in the NYMEX Natural Gas Futures contract.

We recently completed an analysis of hedge fund participation in several NYMEX markets during 2004, which is being submitted to the Committee for the record. NYMEX research suggests that hedge funds serve an overall constructive role in the futures markets. While their participation has not made up a large proportion of our markets to date, we continue to monitor it closely.

At NYMEX, the clearinghouse is operated as another department of the Exchange, also fully regulated by the CFTC. NYMEX's clearinghouse function provides a financial guaranty for all transactions executed on the Exchange, and also for transactions executed off-Exchange but accepted by a NYMEX clearing member firm for clearing through the clearinghouse. The clearing function protects market participants against counterparty credit risk – the risk that either party to a transaction (buyer or seller) could fail to pay such funds due to his or her counterpart as a result of the trade.

Through a system of cross-guarantees among the brokerage firms and banks that comprise NYMEX's clearinghouse, credit risk is mitigated for each participant, because financial performance is generally guaranteed by the clearing member and backed by the Exchange. Customer funds are held by the Exchange and its clearing members in trust accounts, which are segregated from the exposure and funds of the clearing firm or the Exchange itself. NYMEX specializes in the particular risks associated with metals and energy products. We have developed a fair amount of expertise over the years in monitoring these kinds of markets, and our internal risk management procedures involve strict oversight to regularly evaluate risk.

The Exchange is pleased to have obtained a long-term AA+ credit rating from Standard & Poors, largely in recognition of our comprehensive regulatory procedures and thorough market oversight.

The business of the Exchange is clearly contingent on our ability to ensure the integrity of our markets, and on the confidence of our customers and the broader marketplace in our commitment to doing so. In the wake of the collapse of Enron and revelations about unethical trading activity by some market players, transparency and the ability to guarantee market integrity are indeed among the most critical priorities at NYMEX.

The CFMA revisions of 2000 are working as intended.

In closing, it is my view that the regulated futures industry is more robust and competitive as a result of these common-sense revisions to the CEA made by Congress in 2000. The CFMA regulatory scheme is providing an orderly and secure framework for competitive risk management, most notably through a period of major upheavals in the energy sector. In short, the landmark legislative revisions are working as they were intended and no adverse consequences in our markets have resulted from their implementation. I am extremely confident in the ability of current self-regulatory programs at regulated markets to maintain orderly, transparent markets and afford appropriate customer protection.

Finally, although the CFMA ultimately came about because of a strong consensus among a number of key industry constituencies, it is worth noting that the final bill nonetheless included a good number of delicate compromises. Consequently, changes in

one area affect and thus could necessitate changes to many other aspects of the regulation.

NYMEX believes that the CFTC followed closely the intent of Congress when implementing the CFMA and that the industry has flourished the way both the Congress and the marketplace envisioned.

Mr. Chairman and Members of the Committee, NYMEX thanks you for your consideration and pledges its full support to work with you and your staff in this reauthorization process and to address constructively any issues that may be of concern to you or that might otherwise arise in this process. Thank you very much.

TESTIMONY OF
FREDERICK W. SCHOENHUT, CHAIRMAN
NEW YORK BOARD OF TRADE

Before the
SENATE COMMITTEE ON AGRICULTURE, NUTRITION, & FORESTRY
March 8, 2005

Mr. Chairman, thank you for this opportunity to testify on behalf of the New York Board of Trade regarding the reauthorization of the Commodity Futures Trading Commission (CFTC). My name is Frederick Schoenhut and I am Chairman of the Exchange.

In 2004, the Coffee, Sugar & Cocoa Exchange, Inc. (CSCE – founded in 1882) and the New York Cotton Exchange (NYCE – founded in 1870) formally became one exchange, the New York Board of Trade (NYBOT or "Exchange"). Like its predecessor exchanges, NYBOT is a not-for-profit membership organization established under New York law.

NYBOT is the premier world market for futures and options in cocoa, coffee, cotton, orange juice, and sugar. The Exchange also provides markets for futures and options based on the U.S. Dollar Index, Russell U.S. Equity Indexes, Reuters/CRB Futures Index and currency cross rate contracts. While these financial markets exhibit different underlying characteristics than the agricultural commodities that dominate the Exchange, they all provide reliable tools for price discovery, price risk management and investment. In 1994, NYBOT established a trading floor in Dublin; the first U.S. exchange open outcry trading facility in Europe.

Under the Commodity Exchange Act (CEA), NYBOT's markets are "designated contract markets (DCMs)." This means the Exchange has demonstrated to the Commodity Futures Trading Commission (CFTC or "Commission") that it has systems in place to ensure a transparent and fair trading environment and to protect the financial integrity of transactions. As a DCM, NYBOT establishes rules that govern trading, monitors for compliance, and enforces it rules through disciplinary actions, and the CFTC regularly reviews the Exchange's implementation of these functions.

The concept of self-regulation, long embodied in the CEA, was strongly reinforced and expanded by the Commodity Futures Modernization Act of 2000 (the "CFMA"). Specifically, in Section 2 of the CFMA Congress declared that among the purposes of the Act are:

1. to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the CEA; and
2. to transform the role of the CFTC to oversight of the futures markets.

The CFMA was the culmination of four years of work by the Congress. It provided flexibility for exchanges to decide how to best structure their businesses around a set of "Core Principles." The CFTC provides oversight, rather than promulgating prescriptive regulations and second-guessing exchange decisions.

We believe the CFMA is working as intended, allowing markets to be competitive by modernizing and streamlining the regulatory system. Thus, we believe the CEA does not need amendment and recommend a clean, 5-year reauthorization bill.

Market Participants

Market participants are generally categorized as "hedgers" and "investors." Hedgers are commercial firms that trade futures and options to reduce their price risk exposure in the cash market, to protect their profit margins, and to assist in business planning. In a mature market such as sugar or cotton, nearly all levels of the marketing chain of the underlying commodity are represented at one time or other in the trading ring. For example, in the case of cotton, this would include producers, ginners, merchants, shippers, textile manufacturers, and retailers. Hedgers also play an important role in Exchange governance, by serving on commodity committees that review contracts to make sure their terms and conditions are up-to-date with commercial practices.

Investors are attracted to the markets because there are opportunities to profit from price changes as contracts are traded. Because they enlarge the pool of traders, it is easier for market participants to find a buyer or seller and market liquidity is improved. They are therefore critical to the risk management and price discovery functions of the markets.

Investors typically trade through futures commission merchants (FCMs) or through introducing brokers that have clearing relationships with FCMs. Investors also participate in the markets through commodity funds, which are managed by commodity trading advisors (CTAs). All such individuals, firms and their associated persons must be registered with the CFTC and hold membership in the National Futures Association, a self-regulatory organization registered with the CFTC that is charged with enforcing ethical standards and customer protection in the futures industry.

On the floor of the Exchange, trades are executed by floor traders (also called "locals"), who trade for their own accounts, and floor brokers, who execute customer orders. Floor brokers may be "dual traders," meaning they execute customer orders and trade for their own account. The participation of locals and dual traders is critical for maintaining liquidity on NYBOT's markets. All floor traders and brokers must be registered with the CFTC and guaranteed by a member of the New York Clearing Corporation (NYCC). NYBOT is the sole shareholder of NYCC, which is registered with the CFTC as a derivatives clearing organization ("DCO").

The membership of the Exchange includes representatives from all segments of the commercial industries served by NYBOT markets, as well as FCMs, floor brokers, floor traders and CTAs. A full membership allows a member to trade any of the Exchange's futures and options contracts. The Exchange also issues options trading permits that allow the trading of options contracts and "FINEX" permits that allow the trading of financial products in New York or in Dublin.

Trade Matching, Monitoring and Clearing

On NYBOT, all of the details of each trade are entered by the clerks for floor traders and brokers into the NYBOT Trade Input Processing System (TIPS), which automatically matches trades on an ongoing basis. When trades are matched, they are allocated to the appropriate NYCC clearing members that are carrying the relevant account. By the end of each day, all trades are financially settled by the NYCC, and the clearinghouse assumes the opposite side of the clearing members' positions, serving as buyer to every seller and seller to every buyer. Since the NYCC provides financial security for all transactions, counterparty credit risk is not a concern.

The strength of the futures contract is drawn from the clearinghouse guarantee of performance. The safeguards used by the NYCC include stringent financial requirements and clearing member position limit, as well as guarantee deposits from its clearing members.

TIPS data also is used by the Exchange to establish an audit trail, which provides the sequence and execution time of each trade, to the nearest minute. Programs are run to identify any sequences that may indicate trading ahead of a customer's order or other illegal trading activity. Thus, these systems provide powerful monitoring and enforcement tools, and their existence deters violations.

Exchange Governance

NYBOT's Board of Governors establishes and interprets the Exchange's rules and regulations and approves all rule changes and contract modifications. Exchange committees, comprised of members and public members, work with NYBOT staff to develop policy and recommend changes to the contracts and operations. Our trade committees have the ultimate authority with respect to contract specification and must approve any changes before they may be implemented by the Board.

The senior management of NYBOT, under the leadership of the President and CEO and the oversight of the Board of Governors, is responsible for the day-to-day management of the Exchange.

Consistent with Core Principle 16, the NYBOT Board consists of 25 voting governors and one non-voting governor (the president, who is the sole staff representative to the Board). NYBOT By-Laws currently require representation from each major community in its membership on its Governing Board, as well as public members. Therefore, governors include members who represent the commercial industries associated with the products traded on the Exchange, members who trade for themselves or others on the trading floor, FCMs and public governors.

Diversification of Board membership is beneficial to protect the public interest and the economic self-interest of the markets. It provides the Board with a level of expertise that can only be provided by people who are actively engaged in the trading of the products and also allows the Board to take a range of views into consideration before reaching a decision.

As a matter of general corporate law, the fiduciary duty of a director is to the corporation itself and not to any particular constituency. Thus, NYBOT's reason for diversification is not to have spokespersons on the Board for different Exchange constituencies; rather, it is to assure that a range of expertise is represented during the deliberative process.

Five (equal to 20%) of NYBOT's voting governors are denominated as "Public Governors," who are individuals that are not NYBOT members or affiliated with NYBOT member firms. These Public Governors are appointed by the Board. The current Public Governors include a faculty member of a prestigious school of business administration, a principal in a merger and acquisition firm, a consultant on legislative affairs, a senior official at a bank and a commodity trading adviser.

How Board members are chosen, whether to have such diversification, and how representation of various communities should be allocated, are matters for each DCM to determine for itself in light of its own particular circumstances.

Disciplinary Procedures

DCM Core Principle 2 states that an exchange "shall monitor and enforce compliance with the rules of the contract market." The CFTC conducts regular rule enforcement reviews to determine whether an exchange is meeting this requirement. We believe this current system works well and should not be changed.

NYBOT has a disciplinary committee comprised of both members and non-members, called the "Business Conduct Committee" (or "BCC"). This Committee serves several functions, including receiving and reviewing written reports concerning possible rule violations from the Compliance Department staff and determining whether a rule violation may have occurred in any particular instance. BCC members also serve as the Hearing Panel in the event a disciplinary matter is adjudicated.

Each review as to whether a rule violation may have occurred is conducted by a subcommittee of the BCC consisting of one non-member of NYBOT and seven NYBOT members drawn from different exchange communities. The subcommittee may refer the matter to the Compliance Department for further action, enter into or approve a settlement agreement with the accused, or refer the matter to a formal hearing. If a matter is referred to a formal hearing, the proceeding is conducted by a separate panel, consisting of three or five BCC members (not including any of those involved in the preliminary determination to refer the matter for a formal hearing), one of whom is a non-member and the others of whom are drawn from different exchange communities. Individuals having a relationship to the respondent are excluded from both the subcommittee and the trial panel. In this way each pre-trial subcommittee and each trial panel has both expertise and impartiality.

Most cases presented to the BCC are very technical in nature and require a strong knowledge of our rules and understanding of trading practices. Were this system changed by requiring a majority of the disciplinary subcommittees or trial panels to be comprised of non-members, it would deprive the system of needed expertise. Moreover, it would be difficult to attract regular panel participants without adequate compensation, thereby placing smaller exchanges that cannot afford to pay public members attractive sums for serving on such panels at a disadvantage. Compensating individuals who perform these functions can be seen as just creating a different potential conflict of interest.

While the NYBOT compliance system has worked successfully for many years, undoubtedly other systems might be employed at other exchanges to equally good effect, and it should be the decision of each exchange as to what system to employ.

Conflicts of Interest

DCM Core Principle 15 states that an exchange "shall establish and enforce rules to minimize conflicts of interest in the decisionmaking process of the contract market and establish a process for resolving such conflicts." The details as to how that is done is, and should continue to be, left to each exchange.

The basic approach taken by NYBOT is to require disclosure of conflicts and disqualify participants who are conflicted. In the case of a proceeding involving a "named party in interest," NYBOT Rule 6.05 provides that any person having any one of a number of specified relationships with the person who is the subject of the proceeding is barred from participating in the proceeding. In cases not involving a named party in interest, NYBOT Rule 6.06 provides that persons having one of a defined category of conflicts of interest may participate in a discussion after disclosing the nature of the conflict, but may not vote on the outcome. In addition, NYBOT is, and presumably other SROs are also, subject to conflict of interest principles contained in state corporate law.

Challenges and Opportunities

Protection of Market Data Rights

While Congress and the CFTC have effectively facilitated a level playing field to ensure that US exchanges can compete internationally, new threats and challenges face us, today. In the global marketplace, protecting the valuable property rights held by exchanges with regard to their market data is an emerging challenge.

Real-time market data include a continuous stream of prices, as well as volume, open interest, and opening and closing ranges for actively traded contracts. Exchanges sell this information to licensed vendors, which in turn sell the information to various clients throughout the world. Fees from these vendor contracts provide about one-fourth of NYBOT's annual income, with the other income primarily generated from trading fees. This income is used to maintain the systems and platforms that allow NYBOT's markets to function effectively and efficiently so they can serve their intended price discovery and risk management functions. Anything that threatens the income from vendor contracts actually threatens the viability of the Exchange.

Over the past few years, we found our proprietary, real-time market data being published on a website in China. Yet, none of our vendors have reported selling this information to the owner of the website. Thus, we are not collecting the fees. We have joined with several other US futures exchanges to investigate this problem and wrote to the US Trade Representative to report this apparent piracy as the USTR reviews China's compliance with intellectual property rights agreements.

Warehouse Act of 2002 Creates New Opportunity

In 1990, CSCE created a computerized, physical commodity delivery system that addressed sampling, quality, weighing, title transfer, and confirmation of the title status of deliveries. It streamlined the delivery process by eliminating many duplicate paper records, phone calls and faxes, saving time and money for the Exchange and its market users.

In 2003, NYBOT transformed this closed system into "eCOPS" – a web-based Electronic Commodity Operations and Processing System. It can process all forms related to coffee and cocoa deliveries using the internet. With enactment of the 2002 Warehouse Act, we were able to move eCOPS a step further. USDA recognized NYBOT as an official provider of Electronic Warehouse Receipts for coffee. All Exchange coffee deliveries have been transferred to the new system and it is also being used for non-exchange certified coffee. Through these types of innovations, NYBOT serves the broader needs of its market users.

Connecting with Customers

Price volatility is a challenge for agricultural-related businesses in the United States and around the world. Yet, many producers and businesses are not fully aware of or comfortable with risk management tools. Bridging this knowledge gap is an important function of the educational materials and programs designed by the Exchange.

There are many examples. In cooperation with Cotton, Inc., NYBOT sponsors a series of options seminars to provide step-by-step guidance on the use of cotton options for risk management. For our international products, we have worked with UNCTAD, the World Bank and directly with producers and firms in developing countries to assist them in utilizing futures and options. Business and government leaders from many countries and US industries regularly visit the Exchange and participate in educational programs, as well.

Looking Forward

On September 11, 2001, NYBOT was the only exchange completely destroyed in the World Trade Center terrorist attack. Fortunately, one of its predecessor exchanges had built a back-up trading floor in Long Island City following the 1993 bombing of the World Trade Center. Using this facility, NYBOT opened trading on September 17, 2003.

In September 2003, NYBOT returned to lower Manhattan and moved into its new facility at the World Financial Center. In 2004, we hit a record trading volume of approximately 32 million contracts, representing an increase over 2003 volume of 32%.

Mr. Chairman, we thank the CFTC and the Congress for your support after the disaster. And, we thank the members of this Committee and the Congress for the assistance you gave New York and our Exchange, allowing us to rebuild.

I would be happy to answer any questions you may have.

STATEMENT OF SATISH NANDAPURKAR,
CHIEF EXECUTIVE OFFICER, EUREX US,
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
MARCH 8, 2005

Eurex US appreciates this opportunity to testify before the Senate Committee on Agriculture, Nutrition and Forestry on reauthorization of the Commodity Exchange Act. The Committee is to be commended for undertaking a thorough review of the Act, particularly the amendments enacted as the Commodity Futures Modernization Act of 2000 ("CFMA"). In the opinion of Eurex US, those amendments are working as Congress intended, namely by promoting competition, innovation, and efficiency for end users. The Commodity Futures Trading Commission ("CFTC") has adequate authority to ensure investor protection and fair competition among market participants are protected. The Committee should stay the course and encourage competition and innovation to transform the U.S. futures market further.

Introduction to Eurex US

Eurex US began operation in February 2004 as a U.S. futures exchange, registered with and regulated by the CFTC as a "designated contract market."[1] Our designation followed application to the CFTC, with public notice and comment. Eurex US is headquartered in the Sears Tower in Chicago and run by a U.S. management team reporting to a U.S. board of directors.

Eurex US features a completely electronic trading platform. This offers all market participants equal, low-cost access to trading and to information. Trading on Eurex US does not require payment of any membership fee. Trading on Eurex US began in February 2004 with four U.S. Treasury futures products, namely futures on the 2-, 5-, and 10-year Treasury notes and on the 30-year Treasury bond, as well as options on those futures. Just last month, Eurex US made significant expansions to its product line. We launched trading in the world's first derivative product based on 3-year U.S. Treasury notes. We also began trading futures on two equity indices, the large-cap Russell 1000 index and the small-cap Russell 2000 index. Trading volume on Eurex US reached a monthly high in November 2004 of 1.15 million contracts. Daily records were also set that month in overall volume and open interest.

Clearance and settlement services for all trades on Eurex US are provided by the Clearing Corporation in Chicago, a CFTC-registered "derivatives clearing organization." The Clearing Corporation is a venerable financial institution that has been in operation in

[1] As a U.S. exchange, Eurex US then had to receive clearances from foreign regulators in order for participants in those countries to trade directly on the exchange. Subsequent to the CFTC's action, Eurex US received approval by regulatory authorities in the UK, France, Spain, Italy and the Netherlands, among others.

Chicago for 80 years and is widely regarded as a preeminent U.S. provider of futures clearing services to the financial and agricultural trading communities. Eurex US has contracted with the National Futures Association, a CFTC- licensed self-regulatory organization headquartered in Chicago, to conduct market and trade practice surveillance of the exchange and to perform other regulatory duties. The NFA is widely regarded as the leading provider of outsourced self-regulatory services to U.S. futures exchanges.

Eurex US is majority owned indirectly by Eurex Frankfurt AG, the world's largest derivatives exchange.[2] A minority ownership stake in Eurex US is held by a group of 17 U.S. and international financial institutions, including Citigroup Global Markets, Inc.; Goldman Sachs & Co.; Lehman Brothers Inc.; Morgan Stanley & Co. Inc.; and Refco LLC. These shareholders are entitled to appoint 3 of the 12 members of the Eurex US Board of Directors.[3] Eurex Frankfurt AG nominates an additional six members of the board. Finally, three directors represent proprietary trading/arbitrage firms; institutional investors; and independent clearers respectively. Eurex US believes it has the most diverse and broadly representative board of any U.S. futures exchange.

Eurex US business model: equal access and level playing field

The Eurex US business model offers U.S. market participants, customers, and end-users a variety of benefits, including enhanced market efficiency, greater market transparency, equal market access and lower costs. Currently trading a 21-hour day, on April 3, 2005 Eurex US will begin operating a 23-hour trading day, beginning at 5:00 p.m. Chicago time and continuing until 4:00 p.m. the next calendar day. Eurex US will thus offer trading during the core business hours of all time zones. This creates more trading opportunities for market participants and improves their ability to manage their risk.

Access to Eurex US is available to all market participants who satisfy our non-discriminatory eligibility requirements. All market participants may have the benefit of direct access to the exchange, its favorable rate structure, and its competitive and non-discriminatory execution environment. Access is not artificially restricted to a limited number of market participants who benefit from the restricted membership. There are no privileges and no distinction between direct and immediate access of members and indirect access of non-members as is the case on other major U.S. futures exchanges. All market participants experience an equal level of transparency and there are no informational or other trading advantages for any constituency of traders.

Trading on Eurex US is completely anonymous from the time of order entry all the way through contract settlement and delivery. Eurex US has a full, immediate, and

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[2] Eurex Frankfurt is in turn owned 50% by Deutsche Boerse AG and 50% by SWX Swiss Exchange. Deutsche Boerse is a publicly-traded company listed on the Frankfurt Stock Exchange, which it operates. SWX Swiss Exchange is owned by 55 financial institutions.

[3] Kaushik Amin, Managing Director at Lehman Brothers Inc.; Bradford Levy, Vice President at Goldman Sachs & Co.; and Jeffrey Jennings, Managing Director at Morgan Stanley & Co. Inc. are currently serving as directors.

unalterable audit trail of all activity and transactions that occur on the trading platform, ensuring that our customers enjoy the highest level of market integrity and protection.

A further important piece of our efforts to provide open, electronic access to trading and to reduce costs for U.S. market participants is the Global Clearing Link between the Clearing Corporation and Eurex Clearing AG. The benefits of clearing links have been recognized by futures industry market participants and regulators for over 25 years. They allow market participants to enhance liquidity and reduce costs across borders. The Global Clearing Link will facilitate low-cost clearing access to Eurex for U.S. market participants. Customers will benefit from portfolio margining between dollar-denominated and euro-denominated products and one common collateral pool, greatly reducing costs. It will bring new business opportunities to the U.S. by providing the U.S. clearing community with direct access to European trading. By reducing unnecessary payments, it will also reduce systemic risk. Implementation of the Global Clearing Link is subject to regulatory approval from the CFTC and European regulators.

Key Provisions of CFMA and their Impact

The Commodity Futures Modernization Act contained several key provisions. These included:

- Reducing the barriers to entry for new U.S. futures exchanges by requiring the CFTC to act expeditiously on applications;
- Establishing a tiered, streamlined regulatory structure for U.S. futures exchanges;
- Providing exchanges greater autonomy to innovate by greater reliance on private sector market discipline to shape their behavior and less reliance on overly prescriptive governmental intervention;
- Allowing exchanges to demutualize and utilize different forms of governance;
- Establishing separate registration and regulation of clearinghouses ("derivatives clearing organizations") distinct from exchanges; and
- Providing legal certainty to derivatives contracts traded over the counter.

In our view, and in the view of most commentators, the CFMA unleashed a new degree of competition in the U.S. futures marketplace, resulting in greater innovation and efficiency for market participants. In fact, the CFMA was motivated in part by a desire to enable U.S. futures markets to compete more effectively, and without undue regulatory burdens, with foreign futures markets. Since enactment of the CFMA, the CFTC has designated eight additional futures exchanges as contract markets, including Eurex US. The CFTC has also registered eight clearinghouses as "derivatives clearing organizations" during that time.[4] This increase in competition among exchanges has, not surprisingly, been accompanied by product innovation and lower costs. Over 600 new products (including securities futures products) have been filed with the CFTC since

[4] "Reauthorization: Let the Debate Begin," CFTC Commissioner Walt Lukken, Futures & Derivatives Law Report, September 2004 ("Lukken article"), at 30-31.

enactment of the CFMA, with the majority "self-certified" by exchanges for immediate trading.[5] There have been major fee reductions, including an 80% reduction in fees charged by the Chicago Board of Trade with regard to the Treasury futures products in which Eurex US competes for trading, just days before our launch.

The increased competition is transforming the U.S. futures industry in other ways as well. Market participants have had the opportunity to express their preference for immediate, anonymous, and efficient electronic trading and the exchanges have been forced to respond. Even at certain futures exchanges that maintain open outcry trading floors, electronic trading now represents over half of all trading.[6] The result has been a phenomenal increase in U.S. futures trading volumes, from 600 million futures and options contracts traded on U.S. exchanges in 2000 to over 1.6 billion in 2004.[7] Exchange-traded futures volume has grown much faster in the five years since 2000 than in the five years preceding it, with 2004 representing a record year for major U.S. futures exchanges.

We believed that U.S. market participants would welcome the opportunity to trade U.S. and European contracts on a low-cost, efficient, electronic designated contract market. We suspected that our entry would not only lower trading costs for U.S. market participants but would act as an engine for overall growth in the U.S. futures market, to the benefit of all markets and market users. Such seems to be the case.

Looking forward: Congress should stay the course

In our view, there are three basic requirements for futures trading:

- A critical mass of companies and individuals willing and able to use the markets efficiently;
- A tradition of operating transparent financial markets open to all; and
- A regulatory structure that protects market users without encumbering the operation of markets.

Thirty years ago, the United States was the only country in the world that satisfied these requirements. Today, the idea of futures markets has spread across the globe and new markets have developed around the world. European exchanges in particular introduced electronic trading systems that attracted traders not just from their European home markets but from the rest of the world and the United States as well.

The U.S. Congress responded to these developments overseas by placing its faith in competition. By reducing barriers to competition, the CFMA ensured that greater innovation and efficiency would be the engine of growth for the U.S. futures industry.

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[5] Lukken article at 31.

[6] "The Future is in Futures," speech by CME Chief Executive Officer Craig S. Donohue, FIA Law and Compliance Division, February 22, 2005.

[7] Testimony of Sharon Brown-Hruska, Acting Chairman, Commodity Futures Trading Commission, before the House Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, U.S. House of Representatives, March 3, 2005, at 2.

The CFMA put the U.S. futures industry in the forefront of new developments. In its way, Eurex US is trying to realize the potential created by the CFMA. We are offering the U.S. marketplace an open access, all-electronic trading venue; new products; and competitive trading in existing products. The CFMA has greatly facilitated our ability to do all these things.

Eurex US urges the Committee, in reauthorizing the Commodity Exchange Act, to stay the course: continued reliance on the benefits of competition will preserve the U.S.'s leadership role. Abandoning competition to return to prescriptive regulation or to promote protectionism would threaten the benefits that Congess foresaw and that U.S. market participants are now enjoying. The Committee should ensure that U.S. market participants continue to enjoy the benefits of competition. The faith that the Congress placed in the virtues of competition five years ago has been amply demonstrated to have been deserved. Competition will continue to yield greater efficiencies for consumers and the markets as a whole.

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF JOHN M. DAMGARD, PRESIDENT
FUTURES INDUSTRY ASSOCIATION

MARCH 8, 2005

Chairman Chambliss, Ranking Member Harkin, members of the Committee, I am John Damgard, president of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today. FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants (FCMs) in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members serve as brokers for more than ninety percent of all customer transactions executed on United States contract markets.

Little more than four years ago, Congress passed and President Clinton signed into law the Commodity Futures Modernization Act (CFMA). With the goal of promoting "responsible innovation and fair competition among boards of trade, other markets and market participants," the CFMA amended the Commodity Exchange Act to:

- Authorize the Commission to develop a regulatory program for markets that would be "tailored to match the degree and manner of regulation to the varying nature of the products traded thereon, and to the sophistication of the customer;"

- Remove the 20-year prohibition on futures on individual securities and narrow-based securities index contracts and, in another radical departure, provided for the joint regulation of these products by the Commission and the Securities and Exchange Commission; and

- Assure legal certainty for over-the-counter derivatives.

The CFMA signaled a dramatic, new approach to the regulation of the derivatives markets and, as such, placed enormous demands on the Commission and its staff as they developed the regulations necessary to implement its myriad provisions. They have met the challenge, and we appreciate their efforts. While FIA and the CFTC do not see eye to eye on every issue, we believe the CFTC is an excellent federal agency that discharges its statutory obligations in an efficient and effective manner. The CFTC's past and present leadership is to be commended for this record. The CFTC deserves to be reauthorized.

This morning, I want to discuss four issues that FIA believes should be addressed in order to fulfill the promise of the CFMA: promoting fair competition, SRO governance; security futures; and over the counter retail foreign currency (FX) transactions. In each of these areas with one exception (retail FX fraud), it may be possible to address our concerns without specific legislation. At this time, therefore, we are not proposing language to amend the statute. We will continue to work with the Commission and other entities in the futures industry to find both non-legislative and legislative solutions. Nonetheless, at this stage of the process, we want to let you know what issues are of most importance to our members.

Fair Competition. Promoting fair competition should be the goal of any sound regulatory program. Our strong support for the CFMA was based in substantial part on our belief that competition, rather than a prescriptive regulatory structure that established excessively high barriers to entry, would be the best regulator. We fully anticipated that the CFMA's regulatory reforms would encourage new entrants to apply for designation with the Commission as contract markets or clearing organizations. These new self-regulatory organizations would compete among themselves and with the existing exchanges for customer business based on products, quality of execution and cost.

Robust competition facilitates the ability of U.S. futures markets to serve the public interest. Competition leads to reduced costs, higher volumes, narrower spreads and greater innovation. It is true that the efforts of the challenger markets to date have not been successful in doing more than chipping away at the entrenched markets' dominance. Nonetheless, we have seen that some benefits of competition may be achieved, at least in part and for some period of time, even when direct meaningful competition is only threatened, but not realized.

The Chicago Board of Trade's U.S. Treasury security complex is a good example. Spurred by a string of exchanges attempting to offer direct competition in recent years, including the largest derivatives exchange in the world (EUREX), the CBOT has embraced electronic trading and lowered trading costs. The result? Record CBOT trading volumes, greater liquidity, narrower bid-ask spreads and ultimately lower taxpayer costs for funding U.S. government debt. This competitive threat also accelerated first the acceptance and then the recent expansion of electronic trading at the CBOT.

This is just one example. In addition, Euronext Liffe now attempts to compete with the Chicago Mercantile Exchange for Eurodollar futures trading. The CBOT is challenging the COMEX, a division of the New York Mercantile Exchange, for gold and silver futures trading. The IntercontinentalExchange, even without offering futures contracts, competes with the New York Mercantile Exchange for clearing of off-exchange products and trading in energy derivatives.

This incipient competition has even sparked movement in overseas markets. The CBOT is attempting to compete with Eurex for futures trading volume in the German government-issued debt securities the Bund, Bobl and Schatz. And NYMEX has announced plans to face off in London with the International Petroleum Exchange for trading in Brent Oil futures. In sum, at no time in the futures industry's history have we seen as much head to head, direct product competition among markets.

While competition has a very positive influence on markets, it presents certain regulatory challenges. These are most pronounced under the Commodity Exchange Act, which was not designed with these forms of direct competition in mind. Traditionally, once a market achieved liquidity and dominance in a particular product, no challenger emerged. Traditionally, trading and clearing were inextricably linked, one function supported the other and shut out potential competitors that might want to offer similar services. In fact, traditionally, few markets even attempted to challenge dominant markets by offering a new contract design, method of trading or clearing efficiency.

But now that is slowly beginning to change, as the market experience over the past four years shows. More and more, the CFTC's role is evolving to become a referee of competitive disputes between two or more direct competitors for the same product or related clearing services. In each of these struggles—Eurex v. CBOT, Euronext v. CME, ICE v. NYMEX—the CFTC has been called upon to resolve or consider claims of unfair competition. In the ICE v. NYMEX case, even the courts are looking to the CFTC to play a special role in resolving competitive disputes.

This phenomenon raises the question whether the CFTC has the statutory tools to ensure that it can deliver what all referees seek: fair competition under rules of the game that are transparent to all participants. FIA urges this Committee to consider carefully whether reforms are needed in the Act to give the CFTC adequate authority and to give market participants adequate confidence that the CFTC is making sure that no exchange is gaming the system to achieve an unfair competitive advantage.

One area that illustrates some of these issues is self-certification of exchange rule changes. Under current law, an exchange or a derivatives clearing organization has a choice: it may submit a rule for CFTC approval or it may put into effect immediately virtually any rule—no matter its real competitive impact—by self-certifying that the rule complies with the CEA and the relevant core principles. This change in the law was enacted in 2000 to give exchanges the flexibility to respond quickly to market developments without having to obtain CFTC prior approval of rule changes. Usually those rules, especially when adopted in a competitively sensitive area, are not released publicly before the self-certified rule is submitted to the CFTC.

At that point, the CFTC has the authority to take the serious step of rescinding the exchange's self-certified rule change and insisting that the rule be resubmitted for pre-approval. The CFTC, naturally and practically, is reluctant to interfere with the judgment of an exchange or designated clearing organization. But the CFTC has no process in

place to solicit public input on self-certified rules and, therefore, has no way to assess formally the potential competitive impact of an exchange's rule change.[1]

And what if the CFTC takes no action, but a competitor exchange or market participant can make a legitimate claim that the rule change actually constitutes an unreasonable restraint of trade or would otherwise result in unfair competition? The CEA is unclear on what remedies are available to the aggrieved party. No process exists to petition the CFTC or for automatically delaying the effectiveness of an exchange rule that could give the self-certifying market an unfair competitive advantage. As a result, the aggrieved party's only remedies may be litigation under the antitrust laws and the Administrative Procedure Act. That is not the best way to resolve those kinds of disputes. We would like to work with the Committee, the Commission, the exchanges and other relevant parties to try to build a better process for making sure the self-certification authority does not become a haven for unfair competitive tactics.

Finally, some believe that unless or until Congress or the CFTC mandates contract fungibility among exchanges the potential benefits of meaningful direct competition will never be realized. (Fungibility means, for example, that a "long" contract entered into on Exchange #1 could be offset by a mirror-image "short" contract on Exchange #2 through cooperative or common clearing, and vice versa.) Fungibility gives customers the ability to choose their market and obtain the best price available for an offsetting trade, even if the market with the best price is not the market where the original position was established.[2] These are salutary goals we believe everyone should support in the interest of serving the customer and enhancing competition. Yet, established exchanges are reluctant to surrender their market advantages and would surely oppose efforts by the CFTC to impose fungibility by rule.

As noted above, the efforts of the challenger markets to date have done little more than chip away at the entrenched markets' dominance. At this time, however, FIA is not asking this Committee to consider amendments to mandate fungibility. We believe that further study of the current regime of direct competition without fungibility under the CEA is needed before Congress considers such a major reform.

SRO Governance. FIA supports the important role that the exchanges, clearing organizations and the National Futures Association (NFA) perform as self-regulatory

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[1] FIA's concerns about the internal exchange rule approval process and the Commission's lack of procedures for soliciting comment on exchange rules that have been submitted for approval are set forth in a later section of this testimony. (Infra at p. 5.) We have focused on the self-certification of rules in this section in order to illustrate the implications that new authority may have where dueling exchanges could be submitting conflicting or confusing self-certifications of rules as a means for responding to their direct competitors.

[2] Fungibility also would encourage customers to enter into original positions on a challenger exchange when that exchange offers the customer the better price. The customer then could offset that same position on the dominant exchange.

organizations (SROs) and designated self-regulatory organizations (DSROs). Given their strong market knowledge and close proximity to the trading markets, they provide the best vantage point for addressing many of the futures markets' oversight functions. However, to be fully effective, there must be an increased degree of public confidence in the integrity and objectivity of SROs.

The Commission, the several self-regulatory organizations and the derivatives industry generally must act to remove the real and perceived conflicts of interest and potential for anti-competitive conduct that are inherent in any self-regulatory structure. We believe that specific modifications to the SRO structure can increase its overall efficiency and effectiveness. In addition, a clear delineation of the role and responsibility of the Commission in proactively overseeing these SRO functions will enhance SRO performance and public confidence in the SRO structure. We presented our recommendations in this area to the Commission in a position paper and subsequent comment letter on governance of self-regulatory organizations in June 2004. We have attached these documents for the Committee's consideration. In the event the Commission concludes it needs additional statutory authority to implement these recommendations, we summarize two of our recommendations for your consideration.

Certain of the core principles enacted in the CFMA form the foundation of our recommendations. Specifically:

- Core principle 15 requires exchanges to "establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest;" and

- Core principle 18 requires exchanges "to avoid (1) adopting any rule or taking any action that results in any unreasonable restraint of trade, or (2) imposing any material anticompetitive burden on trading," "unless appropriate to achieve the purposes of the Act".[3]

Participation in Rulemaking. The rules that an SRO adopts and the manner in which it enforces them are critical to complying with these core principles and, as important, to properly meeting its responsibilities as an SRO.

Among other requirements, section 5(b) of the Act, which sets out the criteria for designation as a contract market, imposes on exchanges the obligation to adopt and enforce rules (1) to ensure fair and equitable trading, (2) to ensure the financial integrity of transactions entered into by or through the facilities of the exchange, (3) to prevent

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[3] In a statutory anomaly, the core principle for contract markets and anticompetitive conduct appear to be more lenient that the core principle for derivatives clearing organizations and anticompetitive conduct. The Committee may want to revisit these principles and harmonize them. FIA sees no reason for different statutory formulations of an SRO's duty to avoid anticompetitive outcomes from its actions.

market manipulation, and (4) to discipline members or market participants that violate such rules.

To both enhance the quality of SRO rulemaking and engender confidence in the SRO rulemaking process generally, the procedures by which an SRO adopts and enforces these rules should be transparent and should assure that members and other market participants, not just one constituency, have an opportunity to express their views and otherwise participate in the process. The ability of market participants to have a role in developing the four categories of rules referenced above is particularly important, since they are most directly affected by such rules. In this regard, it generally would not be acceptable if such rules were developed solely by SRO staff and approved by the independent directors of the exchange or independent members of a committee.

Neither the Act nor the Commission's rules prescribe the procedures that an SRO should follow in adopting rules. Nonetheless, we believe the essential elements of these procedures are implied in Part 40 of the Commission's rules. These rules require an exchange to describe any substantive opposing views expressed with respect to the proposed rule that were not incorporated into the proposed rule. Further, an SRO, in submitting a rule for approval, must include in its submission an explanation of the operation, purpose and effect of the rule, including, as applicable, a description of the anticipated benefits, any potential anticompetitive effects, and how the rule fits into the framework of self-regulation.

Part 40 contemplates an open, fully informed internal process before an SRO adopts a rule. We do not understand how the Commission could properly determine whether the SRO's rules violate applicable core principles—including the requirement that the SRO endeavor to avoid adopting any rule that results in an unreasonable restraint of trade or imposes any material anticompetitive burden on trading—unless the SRO's rulemaking procedures are designed to solicit input from members and affected market participants on significant rule proposals.

To the extent that affected market participants are not afforded an opportunity to have their views taken into account when an SRO adopts rules, they must have the opportunity to seek redress with the Commission. Transparency in the Commission's consideration of SRO rules and the opportunity for public participation in this process is no less important than in an SRO's adoption of such rules. In appropriate circumstances, a request for comment should be published in the *Federal Register* as well as on the Commission's website, and the public should be afforded a reasonable amount of time to analyze the rules and prepare comments. The Commission's decision with respect to such rule, including its analysis of the comments received, should also be made available to the public.

We want to be clear that FIA is not seeking a return to the rule review procedures that were in place prior to the enactment of the CFMA. Nonetheless, it may be appropriate to identify a select category of rules, primarily those relating to clearing and

certain trading rules, on which market participants should be afforded the right to comment, either at the exchange level or at the CFTC.

Director Independence. To minimize the risk that an SRO could use its regulatory authority for inappropriate purposes, or fail to use it in necessary circumstances, SRO boards and committees should include more independent members. In particular, a committee of the exchange/clearing house board of directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities.

The independent board committee should have direct and unfettered access to information to ensure that it is making fully informed decisions. Further, it should have the ability to retain independent outside counsel in appropriate circumstances. Finally, FIA believes that the nomination process for independent directors of SROs should be free of management or member influence. Accordingly the nominating committee for the independent SRO board supervisory committee should be comprised only of independent individuals who meet the requisite independence test for directors.

FIA continues to have concerns about some definitions of "independent director." We are not convinced that current exchange and others' definitions of "independent" are adequate to achieve true independence. Some current standards define "independence" merely as not having a relationship with the SRO as an entity. Consequently, exchange members are considered independent, a result with which we respectfully disagree. At a minimum, FIA believes that true independent directors should not be currently active in the industry or too recently associated with an SRO member.

The Commission should use its authority under the Act to require SROs to implement the reforms outlined above and to ensure continued compliance. These changes would ensure greater independence of the board generally and the key committee described above to screen out inappropriate appearances of bias or conflicts. As a consequence, the changes would help SROs achieve the goal of greater independence of the regulatory function.[4]

Security Futures Products. FIA has devoted significant time and resources since the enactment of the CFMA, in working with the CFTC, the SEC and the exchange community to implement both the spirit and the letter of the provisions authorizing trading in security futures products. Although volume on these markets has not been as robust as we would like, we continue to believe that this is an important product that will grow over time.

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[4] In a letter to the Commission commenting on proposed revisions to the Joint Audit Agreement to be entered into among the several self-regulatory organizations, FIA made certain recommendations concerning the allocation of SRO responsibilities. This letter is attached to this testimony for the Committee's information.

U.S. futures exchange representatives have made suggestions for changing the law to expand and enhance the trading of security futures products on U.S. markets. We fully support the U.S. exchanges in this effort. FIA wants to be certain that its members and their customers are able to trade as many diverse and innovative contracts on exchanges as possible in order to enjoy the many benefits exchange trading affords. In this regard, FIA would support a careful examination of the regulatory structure governing security futures products to determine whether that structure is unnecessarily inhibiting the growth of these products in the U.S.

However, U.S. institutional investors are also being thwarted in their desire to trade futures on individual securities and narrow-based security index futures contracts traded on a non-U.S. exchange. These instruments could be of significant value to customers for various purposes, including risk management and asset allocation. Although volume in security futures products has grown slowly on OneChicago, the only U.S. exchange listing security futures products, growth on non-U.S. exchanges has exploded. From 2003 to 2004, for example, volume in futures on individual securities grew 58 percent, from approximately 54.3 million contracts to approximately 85.7 million contracts. On Euronext Liffe in London, volume in futures on individual securities doubled and surpassed the volume in options on individual equities.

In enacting the provisions authorizing security futures products, Congress instructed the SEC and the CFTC "to the extent necessary and appropriate in the public interest, to promote fair competition, and consistent with promotion of market efficiency, innovation and expansion of investment opportunities" to "issue such rules regulations or orders as may be appropriate to permit the offer and sale of a security futures product traded on or subject to the rules of a foreign board of trade to United States persons." Consistent with this explicit congressional direction, FIA had been assured that necessary rules or orders permitting the offer and sale of foreign security futures products to U.S. persons would be adopted contemporaneously with the rules authorizing security futures products on U.S. exchanges. However, the CFTC and SEC have failed to take any action to permit U.S. customers to trade futures on individual securities or on narrow-based indices listed for trading on non-U.S. exchanges.

The only action the CFTC and SEC have taken with respect to non-U.S. security futures products is to issue an order to confirm that U.S. customers could continue to trade those broad-based foreign index contracts that had been approved for trading prior to the enactment of the CFMA. This order was necessary because the agencies have not adopted a rule to define a narrow-based index in the context of a non-U.S. index.

The investment objectives of pension plans, investment companies, endowments, hedge funds and other large money managers that FIA members serve have been restricted by the agencies' failure to act. Those institutional customers are free to engage in transactions in the international securities markets with few regulatory limitations. Moreover, these institutions are authorized to enter into principal-to-principal derivatives transactions that replicate foreign security index contracts, but may be more difficult, and

substantially more expensive, to effect than exchange-traded instruments. In these circumstances, no U.S. regulatory purpose is served by preventing U.S. institutional customers, in particular, from using foreign futures on narrow-based index or single securities, provided that a U.S. stock exchange is not the primary market for the securities underlying such security futures products.

We urge the Committee to direct the CFTC and the SEC to adopt the rules that were contemplated under the CFMA. If the agencies believe that they need additional statutory authority, they should so advise the Committee so that appropriate amendments can be added to the CFTC's reauthorization legislation.

Over the Counter Foreign Currency Transactions. The last topic that I want to discuss with you concerns over the counter foreign currency transactions. As the Committee will recall, the CFMA amended the Act to remove the legal uncertainty arising from the so-called Treasury Amendment to the Act that was first adopted in 1974. The amendments, which implemented the recommendations of the President's Working Group on Financial Markets, had two essential elements.

First, the Commission would have no jurisdiction over OTC foreign currency futures and options transactions effected between eligible contract participants, as defined in the Act. Second, retail customers could effect OTC foreign currency futures and options transactions only if the customer's counterparty for that transaction was among a group of otherwise regulated entities, including banks, broker-dealers and futures commission merchants. Although not expressly stated in the amendments, OTC futures and options transactions effected between retail customers and counterparties that were not among the group of otherwise regulated entities would be subject to the exchange-traded requirements of section 4(a) of the Act and, therefore, illegal. In order to enforce that ban, the CFTC would have to prove in court that the offending transactions were futures or options.

It is important to stop here to emphasize that the CFMA provided the CFTC with these special enforcement powers solely with respect to transactions that are futures or options on foreign currency. The amendments did not purport to grant the Commission jurisdiction over cash and forward contracts. Under the CFMA, the active cash and forward markets in foreign currency would continue to fall outside of the Commission's jurisdiction. (Historically, of course, cash and forward transactions on all commodities have been excluded from the Commission's jurisdiction.) Second, the amendments did not grant the Commission exclusive jurisdiction with respect to such transactions or pre-empt the application of other applicable federal and state laws, both criminal and civil.

The past four years have seen a steady stream of unregistered and unregulated entities engaging in widespread sales practice and financial fraud in connection with off-exchange foreign currency transactions with retail customers. Significantly, these entities have attempted to avoid CFTC prosecution by claiming not to be offering futures on foreign currency. To the contrary, the agreements between these entities and their

customers stated that these transactions would be conducted on the spot market. Nonetheless, applying a multi-factor approach first blessed by the 9th Circuit in *CFTC v. Co-Petro Marketing Group, Inc.*, the Commission has taken the position that these transactions are futures transactions and, therefore, illegal.

The Commission has carried the fight against foreign currency fraud virtually alone, with some help from the Department of Justice. (NFA, of course, has authority to investigate or bring actions against only those entities that are registered and are members of NFA.) With the decision of the 7th Circuit in *CFTC v. Zelener* concerning the legal tests for proving that a transaction is a futures contract, however, the Commission's jurisdiction in this entire area has been called into question. In that case, the court rejected the multi-factor approach and, focusing solely on the terms of the customer agreement, held that the so-called "rolling spot" contracts offered by the defendants were, in fact, spot contracts and not futures contracts.

FIA agrees that the CFMA's approach to granting the Commission enforcement jurisdiction over retail fraud in foreign currency (FX) transactions was imperfect. If Congress determines that the CFTC should use its resources to prosecute retail FX fraud without regard to the nature of the transactions—that is, the CFTC should exercise its antifraud authority over spot and forward transactions as well as futures and options—FIA is committed to working with the Commission, NFA and others in the industry to develop appropriate legislation.

However, any such legislation must be carefully tailored to address this specific problem. We are concerned that the temptation would be to draft legislation that is broad in scope in order to address all OTC transactions in all commodities where a retail participant is a counterparty could inadvertently interfere with legitimate risk management transactions entered into by commercial parties, including, for example, hedge-to-arrive contracts used by many in the agricultural community.

In closing, I would like to remind the Committee that the challenge of combating off-exchange fraud is not new in the CFTC's history. The "open season" provisions in section 12(e) of the Act were adopted in 1982 at the request of the Commission, led by Chairman Philip McBride Johnson, the first chairman appointed by President Reagan. As Chairman Johnson noted, the Commission, given its small size, "simply cannot act as a national fraud strike force." This Committee agreed. In its report on the Futures Trading Act of 1982, the Committee wrote:

> [I]t has become clear that the Commission, by itself, cannot be primarily responsible for policing every enterprise operating under a "commodity" theme. The shape and form of these illegal enterprises are unlimited, given the inventiveness of the person perpetrating the schemes. . . . Making promises of quick profit at little or no risk, these unscrupulous

> persons and their sales staffs seek little more than to part the hapless investor from his money.[5]

In developing legislation to grant the Commission special antifraud authority over OTC foreign currency transactions, therefore, we must be careful not to do anything that would inadvertently discourage state authorities and other federal agencies, such as the Federal Trade Commission, from devoting resources to fighting what is nothing more than a form of consumer fraud. The Commission's primary focus should remain the regulation and oversight of the exchange markets and its participants.

Thank you again for the opportunity to appear with before you today. I would be happy to answer any questions you may have.

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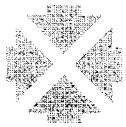
[5] S. Rep. No. 384, 97th Cong. 2d Sess. 26 (1982). Further clarifying the limited scope of the Commission's jurisdiction, Congress also amended the definition of a commodity trading advisor. Prior to the 1982 Act, a commodity trading advisor was broadly defined to include any person who was engaged in the business of providing advice "as to the value of commodities," including cash and forward market transactions. As amended in the 1982 Act, a commodity trading advisor is defined as any person providing advice "as to the value of or advisability of trading in any contract for futures delivery made on or subject to the rules of any contract market, any commodity option authorized under section 4c, or any leverage contract authorized under section 19 of this Act." That is, a person is required to be registered as a commodity trading advisor only if that person is providing advice with respect to transactions that fall within the Commission's exclusive jurisdiction.

DOCUMENTS SUBMITTED FOR THE RECORD

MARCH 8, 2005



New York
Mercantile Exchange

A REVIEW OF RECENT HEDGE FUND PARTICIPATION IN NYMEX NATURAL GAS AND CRUDE OIL FUTURES MARKETS

March 1, 2005

Introduction

In recent months, there has been an increasing focus in the business press on participation by hedge funds in commodity markets, particularly including energy markets. Media attention developed due to complaints from a small number of companies who have expressed concern about substantial price volatility for energy commodities, such as natural gas. These companies have suggested this result is somehow attributable to the trading activity of hedge funds in energy markets. These assertions have been forwarded to the public arena without analysis or facts to support such claims.

The New York Mercantile Exchange ("NYMEX" or the "Exchange") believes strongly in vigorous and spirited discussion and debate on important public policy issues. However, we also believe that such discussions need to be grounded in facts and in thoughtful analysis and that confused or inaccurate assertions can do harm to the public dialogue on the issues of the day. Accordingly, we analyzed the level and impact of hedge funds in two of our largest futures contracts.

As a note, the exact parameters of the entities who might fall within the general term "hedge fund" for purposes of trading on futures markets are not susceptible to precise determination. This term is neither defined by the Commodity Exchange Act nor by NYMEX's rules . It is our sense that this term is commonly understood to refer to private investment funds or pools that trade and invest in various assets on behalf of their clients, who are typically high net-worth individuals. However, we note that commodity pool operators, which are subject to CFTC regulation, may also operate hedge funds.

In this study, the Exchange determined to use an extremely broad scope of reference in analyzing trading activity in our markets. Specifically, the trading activity reviewed in this study not only includes activity by investment funds generally, including private funds as well as more public commodity pools, but indeed even includes as well activity directed by commodity trading advisors. Consequently, this study sets forth the term "Hedge Fund" as a capitalized term in an effort to highlight the fact that the scope that we attribute to this term is being used for the limited purpose of, and thus is only relevant to, this particular study.

NYMEX is a for-profit corporation organized under the laws of the state of Delaware and has been in continuous operation as a commodity exchange for more than 130 years. It currently serves the marketplace as a regulated designated contract market under the regulation of the Commodity Futures Trading Commission for the trading of numerous commodity futures and commodity futures option contracts and as a regulated derivatives clearing organization for the clearing of various products. NYMEX is the largest exchange in the world for the trading of futures and option contracts based on physical commodities. In 2004, total volume at the Exchange, including overall clearing volume, was approximately 169 million contracts. Public investors in our markets include institutional and commercial producers, processors, marketers, hedge funds and users of energy and metals products.

Executive Summary

NYMEX staff analyzed market data related to Hedge Funds for specified periods in 2004 for the Exchange's benchmark crude oil and natural gas futures contracts. These data were available to the Exchange through a reporting system that constitutes one of NYMEX's most important tools for conducting market surveillance. Staff reviewed Hedge Fund activity as reflected in trading volume as well as in open interest. Based upon these available data, this review generated the following conclusions:

- **Hedge Fund trading activity comprised a modest share of trading volume in both crude oil and natural gas futures markets.**

In crude oil, Hedge Funds constituted only 2.69% of trading volume while in natural gas Hedge Funds constituted 9.05% of trading volume during the review period.

- **Hedge Fund activity comprised a relatively modest share of open interest in both crude oil and natural gas futures markets.**

As a percentage of open interest, Hedge Funds constituted 13.4% in the crude oil market and 20.4% in the natural gas market during the review period.

- **Hedge Funds hold positions significantly longer than the rest of the market, which supports the conclusion that Hedge Funds are a non-disruptive source of liquidity to the market.**

- **With regard to price volatility in natural gas futures, when Hedge Fund activity alone is evaluated, the data strongly indicate that changes in Hedge Fund participation result in *decreases* in price volatility.**

- **Even when Hedge Fund activity in natural gas futures is considered in connection with changes in inventory, the data indicate that changes in Hedge Fund participation appear to *decrease* price volatility.**

- **These statistical results are consistent with a positive role provided by Hedge Funds to futures markets.**

On a general level, the trading volume that is provided by Hedge Funds, though incremental, contributes to the overall liquidity of the markets traded and so improves the efficiency of these markets. More specifically, trading by commercial firms emphasizes (but is not necessarily limited to) hedging activity. At any one point in time when a commercial firm submits an order to a futures market, there may or may not be other commercials submitting orders for the other side of the market. Accordingly, similar to floor traders, who are in the business of providing short-term liquidity to a market, Hedge Funds can serve to bridge the gap in liquidity at a point in time that may exist in the

market between commercial participants who wish to buy and those who wish to sell. This intertemporal or "interstitial" liquidity is critically important to any futures market.

NYMEX staff also considered changes in the market fundamentals for the natural gas market. This market has experienced significant shifts and changes in the balance of supply and demand in recent years. In particular, dramatic increases in demand have been the driving force in eroding excess productive capacity. These changes can be cited as clear contributors to the price levels and volatility observed in this market at various points in the last several years.

In conclusion, as noted, Hedge Funds can play a valuable role in futures markets in providing additional liquidity to the market, which benefits all market participants. Moreover, the data from this study indicate that Hedge Funds appear to reduce rather than to increase price volatility in the futures markets that were analyzed. In short, it appears that Hedge Funds have been unfairly maligned by certain quarters who are seeking simple answers to the problem of substantial price volatility in energy markets, simple answers that are not supported by the available evidence.

Participation in Market

Measurement

There are two basic measures of participation in futures markets: trading and open interest. Trading consists of buying (going long) or selling (going short) and Exchanges keep track of the number of contracts traded over different time periods, such as day, week or month. Open interest refers to the number of outstanding obligations in a futures contract at a given point in time. In other words, open interest can be described as the total number of futures contracts (long or short in a contract month of a listed futures contract) that have been entered into and that have not yet been liquidated by an offsetting transaction or fulfilled by delivery. Open interest is typically measured as of the end of a trading day. Consequently, the level of participation in a futures market by a group of participants can be measured as either trading volume over a specific time period or as open interest as of the end of a specific trading day. Below, each of these measures is provided for the applicable review periods.

Background: Physical Delivery Contracts and Market Theory of Price Impact of Non-Commercial Market Participants

Contractual Obligation

Futures contracts for crude oil and natural gas at the New York Mercantile Exchange entail obligations to make delivery (sellers) or take delivery (buyers) of the underlying physical commodity. In practice, most participants in these markets, including companies engaging in hedging, do not, in the end, perform these obligations because they choose to liquidate their outstanding positions in the market before the delivery obligations must be performed. Indeed, only a very small fraction of contracts executed on a futures exchange will result in physical delivery of the cash commodity for a

physically settled contract. Nonetheless, the contracts call for delivery and any participants who do not otherwise liquidate a position take on active delivery obligations.

The ability to perform delivery is one of the boundaries that distinguish commercial participants from non-commercial participants and also distinguish prospective hedgers from speculators. The delivery obligation also imposes on non-commercial participants an unambiguous obligation with respect to trading futures; any outstanding positions in a specific contract must be liquidated before trading in the contract expires. In other words, trading by non-commercials that establish initial outstanding positions in the futures market must eventually be offset by reversing the trade that establishes the position.

Potential Price Influence

This requirement, that non-commercials must engage in offsetting trades before contract termination of the listed contract month for the applicable futures contract, has equally strong implications as to price impacts. If one chooses to accept the logic that, *all other things being equal*, initiation of positions in the market by non-commercials exerts a price influence—i.e., initiating a purchase raises the price from what it otherwise would have been or initiating a sale lowers the price similarly, then one must equally accept the notion that the action of liquidating the position, which must eventually be performed by all non-commercials, exerts the reverse price influence. The unavoidable conclusion of non-commercials being unable to perform delivery is that the net impact of their trading should be neutral with respect to influencing price. Any other conclusion requires a contrivance in logic.

None of this is to say that price influences simply reduce to initiation of purchases or sales without any regard for the complex fabric of transactions that comprise energy markets at large, including futures, cash and over-the-counter financially-settled markets for similar and related products that are sometimes cleared simultaneously and other times cleared sequentially. However, the point does intend to illustrate that it is axiomatic that any influence on price that one wishes to argue somehow emanates from non-commercial participation must be equal and opposite to other price influences that unavoidably emanate from the same non-commercials.

However, the same chain of logic that demonstrates there is no net impact on price by non-commercial participation raises the possibility that increases in non-commercial participation may cause increases in price fluctuations or *price volatility*. This theoretical possibility is considered further below.

Price Volatility

In both the NYMEX crude oil futures market and the NYMEX natural gas futures market, the contracts for the month nearest to termination—commonly referred to as the *spot* month-- are the ones that experience the highest levels of price volatility. There are rarely exceptions to this market experience.

Methodology

Exchange staff has performed several different analyses to evaluate influences on price volatility in NYMEX markets. These analyses have been performed for two periods of time. First, the Exchange collected information on Hedge Fund participation in its crude oil and natural gas markets, measured with respect to trading volume and to open interest, for the time period January 2004 through August 2004.

By comparing the relative percentages of specified non-commercial participation in trading volume versus open interest as well as in the spot month versus other months, it is possible to draw inferences on potential impacts on price volatility. The second period of time analyzed is January 2004 through early November 2004. This analysis is based on open interest alone and compares the influence of Hedge Fund market participation versus other factors on price volatility in the natural gas market. The results from these analyses are reviewed and discussed below.

Data

The open interest information was collected for each day using the Exchange's "Large Trader Surveillance System ("LTRS") and averaged over each of the two periods in terms of percentage of market share.[1] There was no distinction made for long positions versus short positions.

Combined long and short positions were aggregated for "Hedge Funds" and "Investors"[2] and divided by the sum of total long and short positions in the underlying market. Open interest or Large Trader data is only collected for accounts that hold *reportable* levels of contracts, as defined by regulation. As a practical matter, the reportable level of open interest in NYMEX crude oil and natural gas futures contracts is typically 85-90% of total open interest and, for purposes of this evaluation, is considered reflective of the entire open interest.

Trading information for all contract months was collected for Hedge Funds over the January through August time period. In addition it was collected for each month during the period and it was collected for the spot month contract alone. All of the information is expressed as percent of the entire market. (Aggregation of trading data is more complex than aggregation of open interest data, and the Exchange has not performed the aggregation of "Investor" trading. It was determined to include "Investor" open interest nonetheless to be as informative as possible, and it is generally accepted that "Investors" and "Hedge Funds" are similar in terms of their overall roles as non-commercial participants.)

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[1] At the end of every trading day, NYMEX electronically collects from its clearing members and carrying brokers the identities and position levels for those with reportable positions. In general, for purposes of this system, a large trader may be understood to be a trader who holds or controls a position in any one future (or in any one option expiration series) that is equal to or greater than an exchange or CFTC-specified reporting level.

[2] A category used internally by NYMEX staff for certain purposes to refer to non-member speculators and speculative trading proprietary trading groups.

The evaluation did not include in the Hedge Fund or Investor categories any entities that do participate in crude oil or natural gas deliveries. Those entities are considered energy companies.

Analysis 1

The percentage share of open interest and percentage share of trading are compared to make some initial analytical observations. The percentage of spot market trading volume to trading volume in all months is also compared as the basis for analyzing impact on price volatility. Implicit in this comparison is the generally accepted view in the futures industry that, not only is the spot contract the contract month that experiences the highest level of price volatility, but it also has a higher impact on overall price volatility than any other contract month.

Results

Crude Oil
From January through August 2004, Hedge Fund trading constituted 2.69% overall of NYMEX crude oil futures trading. As a percentage of open interest, Hedge Funds constituted 13.4%. In addition, Investors constituted 8.3% of open interest. Hedge Funds' spot trading constituted 58% of their overall trading. For the entire crude oil market over the time period evaluated, the relative trading volume of spot to all months was almost 44%.

The implications of these results are as follows:

- Hedge Funds hold positions, once established, significantly longer than the rest of the market. Constituting only 2.69% of trading while constituting 13.4% of open interest, all other things equal, implies transmitting a minimal impact on volatility. Hedge Funds (and presumably Investors as well) are a non-disruptive source of liquidity to the market.
- Hedge Funds participate to a greater extent in spot month trading than other participants. Because of their relatively higher level of participation in spot, we conclude:
    - It further reinforces the conclusion that their overall influence on price levels is negligible because they must liquidate any outstanding positions during the spot month. Clearly, some of the positions are initiated during the spot month.
    - There could be some impact on price volatility, but it would be negligible because of the overall low percentage of trading attributable to the Hedge Funds—still less than 4% of spot market trading in crude oil.

Natural Gas
From January through August 2004, Hedge Fund trading constituted 9.05% overall of NYMEX natural gas futures trading. As a percentage of open interest, Hedge Funds

constituted 20.4%. In addition, Investors constituted 3.8% of open interest. Hedge Funds' spot trading constituted 44.3% of their overall trading. For the entire natural gas market over the time period evaluated, the relative trading volume of spot to all months was almost 45.9%.

The implications of these results are as follows:

- Hedge Funds hold their positions a significantly longer period of time than other market participants as a whole. Similar to crude oil, this means their participation, in spite of being larger, results in non-disruptive supply of liquidity to the market.
- It appears that investment in natural gas futures is satisfied to a greater relative degree by Hedge Funds than investors acting on their own versus the crude oil market. The total open interest for the two groups, though larger for natural gas than crude oil, is relatively close—24.2% versus 21.7%.
- Hedge Funds participate slightly less in spot market trading, as a percentage of overall trading, than other market participants. The implication of this point is that, all other things being equal, their trading style has a slightly less relative impact on spot market volatility than other participants. Given that their overall trading in the spot market is still about 9% of overall spot trading, we can conclude they could have a modest impact on volatility.

Extension of Trading Data

Subsequently, we calculated the percentage of trading due to Hedge Funds for calendar year 2004 for the Exchange's crude oil and natural gas futures contracts. The levels were: crude oil—3.07%; natural gas—11.13%. Each of these numbers is greater than the corresponding percentages for the January through August 2004 calculations, but neither implies a dramatic increase in participation or change to any conclusion.

Analysis 2

Because of the conclusion that Hedge Funds possibly may have a modest impact on spot price volatility in natural gas markets, we have performed additional analyses on the influences on natural gas price volatility. Price volatility, defined for purposes of this study as the standard deviation of natural gas *spot* futures settlement prices, was calculated by Exchange staff.

In general, two separate influences on price volatility are evaluated and compared—Hedge Fund participation in the market and fundamental market information. The fundamental market information consists of changes in natural gas inventory publicly reported on a weekly basis by the U. S. Department of Energy, Energy Information Administration (EIA). With the exception of weeks in which there are federal holidays, the information is generally released on Thursday mornings. (During exception weeks, the information is released in accordance with a defined schedule that is publicly available.)

Hedge Fund participation was measured by open interest; in particular, by measurement of any change in open interest. Open interest was used, rather than trading volume, because changes in open interest represent unambiguous measures of increases or decreases in market participation. By contrast, trading volume increases or decreases could be associated with either increases in open interest or decreases in open interest, which leads to ambiguity in evaluating influence. The question directly evaluated here is: do changes in Hedge Fund open interest cause changes in price volatility? The review undertaken here also considered whether changes in inventory levels cause changes in price volatility.

To accommodate within this study the fact that inventory data are provided on a weekly basis, the measurements for price volatility and Hedge Fund participation--standard deviations and open interest, respectively—similarly were measured on a weekly basis.

Results

Regression analysis was performed based on data for the period January 9, 2004 through November 5, 2004. Two regressions were performed that examined changes in the standard deviation in the *spot* natural gas contract settlement price versus the changes in Hedge Fund open interest and changes in weekly inventories as announced by EIA. The first regression identified the influence of Hedge Fund open interest alone. The second regression identified the combined influence of Hedge Fund open interest and weekly inventories. The results from the regressions follow below. Note that the standard measurement for evaluating the strength of influence in regressions is expressed in terms of *confidence level* percentages. A traditional convention in statistical analyses governing the use of confidence levels is to associate statistical significance with levels 90% and greater.

- When the impact of changes in Hedge Fund participation is evaluated alone, it indeed does have an influence on price volatility that is statistically significant—a confidence level of over 91%. Interestingly, the influence is *negative*. This means that increases in open interest by Hedge Funds cause decreases in price volatility—i.e., Hedge Fund participation seems to apply a brake to price volatility. However, when Hedge Fund participation is the only influence considered, the resulting regression equation explains a modest portion of price volatility—i.e., the equation correlation is only .27 (R^2=.07)[3]. This means, though Hedge Fund participation, evaluated alone, has a statistically significant impact on price volatility, it does not explain much of the overall price volatility.

[3] Regression equations are lines, constructed from the statistical dispersion of the actual observations, presented in a graph, that intend to fit the dispersion of the observations as closely as possible. The most commonly used measurements as to the snugness of the fit are the equation correlation and its mathematical square, R^2. The correlation and its square can range from a low of 0 to a high of 1. The higher the number, the snugger the fit.

- To account for additional explanation of price volatility, a regression was estimated evaluating the combined influence of changes in Hedge Fund participation and changes in inventory. This regression continues to show changes in Hedge Fund participation having a negative influence on price volatility—i.e., increases in Hedge Fund participation cause decreases in price volatility—but does so with a confidence level of 85%, which is lower than the statistically significant levels associated with traditional convention. The formal phrasing of this result is to note that changes in Hedge Fund participation *appear* to have negative influence on price volatility when taking into account the influence of changes in inventory.
- Changes in inventory have statistically significant influence on price volatility. The relationship is positive—i.e., increased changes in inventories result in higher levels of price volatility. The confidence level is greater than 99%.
- The most recent previous level of price volatility was statistically significant in explaining current levels of price volatility. The confidence level is greater than 99%.
- Overall, these three variables explain only a portion of price volatility, but a significantly larger portion than changes in Hedge Fund participation alone. The equation correlation is .54 with an R^2 equal to .30. Thus, a substantive amount of explanation is provided, but there remains a substantive amount to explain as well.

Interpretation

The regression results indicate that, if anything, increased participation by Hedge Funds diminishes volatility. This result, though not axiomatic, is not surprising. To summarize previous observations, over time, non-commercial trading must, by definition, result in offsetting impacts on prices because non-commercials can not participate in delivery. This leaves open the theoretical possibility that non-commercial trading could result in increasing price volatility. However, as the above statistical results indicate, this is not the case and, if anything, the reverse holds.[4]

These statistical results are not surprising because any construction of hypothetical market dynamics and circumstances that would support Hedge Funds participation causing market volatility inherently suffers from assumptions that are not reasonable. To illustrate this point, if increases in Hedge Funds open interest were to cause increases in volatility, logically, it would be because purchases increase price (from what it would otherwise be) and sales decrease price (from what it would otherwise

[4] The Exchange also performed an intermediate analysis before performing the regression analyses. This consisted of a statistical *Granger Causality* test evaluating whether changes in Hedge Fund participation lead to changes in price volatility or whether changes in price volatility lead to changes in Hedge Fund participation. The period examined was January 2004 through August 2004. The results revealed that there is a 91% likelihood that price volatility leads to Hedge Fund participation — i.e., increased price volatility leads to increased hedge fund participation; furthermore, there is a 86% likelihood that Hedge Fund participation does not lead to price volatility. These results are consistent with the results provided here.

be). To be profitable with such dynamics, it would need to be the case that, somehow, Hedge Funds' purchases are followed by purchases by others that result in prices increasing even more (from what they otherwise would be) and then selling at the higher price; and *vice versa* with respect to sales. Otherwise, it would not be profitable.

For this to succeed, Hedge Funds, in effect, must rely on someone else to trade unprofitably, but who is it that would fall into this category? There are three other fundamental classes of market participant to consider in asking this question: commercial natural gas industry participants; non-commercial participants that specialize in providing liquidity; and other non-commercial participants (i.e., Hedge Funds or entities with similar trading orientations to Hedge Funds). Below, each of these groups is considered.

1. *Commercial Participants*: In fact, they would be expected to be the best informed of any group as to supply and demand of natural gas, cash-market prices and OTC transaction prices. It is not reasonable to argue that the best informed class of market participant would consistently trade so naively.

2. *Non-Commercial Liquidity-Providers*: In fact, their trading practice generally is to bridge the gap in liquidity that exists in the market between commercial participants who wish to buy and those who wish to sell. If commercial orders were always in balance between these two groups, this class of participant would not exist, but, in practice, they are critical to the functioning of the market. Typically, they operate by competing with commercial participants to *improve* the bid-ask spread—i.e., narrow the spread between commercial offers to sell and commercials bids to buy. Rather than follow other participants lead to make purchases, they would be more inclined to compete with someone that wanted to buy and, through that competition, make the bid price higher and, consequently, closer to the ask price. This is significantly different.

3. *Other Non-Commercials* —i.e., Hedge Funds and non-hedge funds that behave like Hedge Funds. In theory, the answer could be yes, but this means that, to be profitable, Hedge Funds must consistently rely on the naiveté of a group of non-commercial investors that continue to participate even though they are consistently unprofitable.

The conclusion from this is that one must rely on unreasonable assumptions as to some participants' behavior to support an assertion that Hedge Funds participation results in a secular rise in price volatility. As the data indicate, this is not the case. In fact, it is much more reasonable to suggest that Hedge Funds' trading strategies involve *responding* to market volatility—i.e., higher volatility attracts Hedge Funds—and, accordingly, their participation tends to *diminish* volatility. The statistical evidence supports this view with a few minor qualifications. The first qualification is that, if one is taking into account only changes in Hedge Fund participation as an

influence, then the effect is statistically significant but only explains a modest level of volatility. The second qualification is that, if one is taking changes in inventory into account as well, the overall influence, though substantive, incorporates estimated influence from changes in Hedge Fund participation that is less statistically significant.

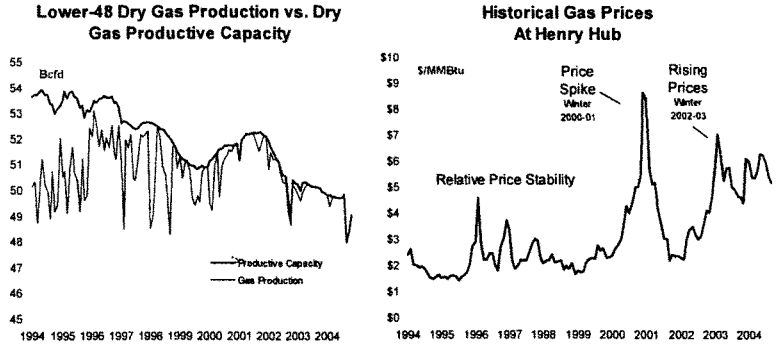
FUNDAMENTAL ANALYSIS

In the past five years, few economic factors have been spared from volatility, which in competitive markets is caused by uncertainty. The natural gas market is no different and significant shifts and changes in the balance of supply and demand can be cited as clear contributors to the price levels and volatility to which participants in this market have been exposed. In fact, as natural gas has re-emerged as a critical and growing component in the nation's energy resource mix since deregulation, dramatic increases in demand have been the driving force in eroding excess productive capacity. The attached charts, which were done by Kevin Petak, an economist with Energy and Environmental Analysis, Inc., show that the timing of relatively high volatility in the natural gas markets coincides with the period that has seen actual gas production levels reach declining productive capacity levels.[5]

In simple terms, it means that producers no longer have an ability to turn the spigot further because production has been flowing at its maximum level for quite some time. The result is that the U.S. resource base of reserves has diminished.

[5] These charts were contained in a number of recent industry presentations, including a November 16, 2004 presentation entitled "Gas-Based Power Generation: Can We Do Without It?" that was delivered at the national convention for the National Association of Regulatory Utility Commissioners ("NARUC"). These charts are included in this NYMEX research paper with the permission of Mr. Petak.

The Changing Gas Balance



Divergent trends in gas supply and demand have led to the tight balance between supply and demand, higher gas prices, and increased price volatility.

TIGHT BALANCE EXPECTED TO CONTINUE

Energy and Environmental Analysis, Inc. 3

In other words, production has not been able to keep pace with demand. As reflected in these charts, the period of this process of elimination of the excess productive capacity has coincided closely with the period of more volatile prices in natural gas markets.

It is not immediately apparent how long this situation will continue. However, high prices have persisted and have attracted substantial investment in productive capacity with domestic exploration and production companies drilling at unprecedented levels, the Alaskan pipeline (and similar significant projects) coming closer to reality and liquefied natural gas firms constructing new liquefaction (overseas) and gasification (domestic) capacity.

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September 30, 2004

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21ST Street NW
Washington DC 20581

Re: The Governance of Self Regulatory Organizations
69 *Fed.Reg.* 32326 (June 9, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA")[1] is pleased to respond to the Commodity Futures Trading Commission's ("Commission") request for comments concerning the governance of self-regulatory organizations ("SROs"), 69 *Fed.Reg.* 32326 (June 9, 2004).[2] This letter expands upon the matters that FIA discussed in the position paper that we forwarded to the Commission on June 8, 2004 ("Position Paper"),[3] a copy of which is enclosed as Exhibit A. Recent developments in the futures markets, such as the demutualization of SROs, competition among organized exchanges and the move to for-profit structures, as well as the development of competing dealer markets for over-the-counter derivatives products, warrant the Commission's careful reexamination of SRO governance. The *Federal Register* release reflects careful thought about all aspects of the efficacy of self-regulation in the futures industry.[4]

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1 FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCM") in the United States. Among our approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including US and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 80 percent of all customer transactions executed on US contract markets.

2 69 *Fed. Reg.* 32326 (June 9, 2004) ("Release"). The Commission extended the comment period to Sept. 30, 2004. 69 FR 42971 (July 19, 2004).

3 Letter to Honorable James Newsome, Chairman, Commodity Futures Trading Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004.

4 FIA has had a long-standing interest in SRO governance issues and, in addition to the Position Paper, has submitted several previous comment letters to the Commission on various SRO governance matters. *See, e.g.*, Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004 (Futures Market Self-Regulation); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated July 14, 2003 (Chicago Board of Trade and Chicago Mercantile Exchange Rules); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated August 16, 2000 (A New Regulatory

Introduction

FIA believes that self-regulation, combined with effective oversight by the Commission, is in the public's best interest — by ensuring the most meaningful and effective protections at the lowest cost. Input from the industry can improve the likelihood that SRO rules will achieve their intended goals. Similarly, input from industry participants can help disciplinary panels evaluate questionable behavior with the benefit of knowledge and experience.

However, FIA is concerned that, in light of the recent developments described above, long-standing conflicts of interest existing in the current SRO structure could lead to problems that might jeopardize public confidence in the fairness of our markets.[5] For example, under the current structure, it is possible that SROs could use their regulatory authority for anti-competitive purposes or to adopt rules that benefit parochial interests at the expense of the public interest. We also believe that the Commission should more extensively evaluate certain rulemaking and regulatory processes at the SROs, and can do so without moving to a prescriptive regulatory environment.

We respectfully suggest that the Commission should take measured actions to strengthen its own oversight functions and to enhance the independence and integrity of the self-regulatory structures within SROs. By so doing, the Commission may prevent problems in the future. FIA believes that these suggestions, although significant, may be viewed as evolutionary reforms to the current system.

Recommendations

In order to minimize the potential for abuse arising from actual and perceived conflicts of interest,[6] FIA recommends that the following four goals inform the SRO governance initiative:

Framework for Multilateral Transaction Execution Facilities, Intermediaries, and Clearing Organizations; Exemption for Bilateral Transactions); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated October 9, 1999 (Petition for Exemption Pursuant to Section 4(c) of the Commodity Exchange Act).

[5] In our comments on the proposed amendments to the Joint Audit Agreement, we noted that "the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement." Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004, p. 3. A copy of this letter is enclosed at Exhibit B. As there, our comments in this letter are designed to reduce the conflicts of interest that are inherent in any self-regulatory structure.

[6] Section 5(d)(15) of the Commodity Exchange Act ("CEA") as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), requires that a board of trade "establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest." *See also* the Release at Question 14.

- Require board-level independence of SRO oversight accountable directly to the Commission;
- Accentuate the separation of an SRO's business and regulatory functions;
- Increase both the transparency of the regulatory process and industry participation in the regulatory process; and
- Better assure the confidentiality of members' proprietary information to prevent improper use.

We believe that the Commission should use its existing authority under the Commodity Exchange Act ("Act"), and in particular, its authority to ensure compliance with the core principles of Section 5(d) of the Act, to achieve these goals.[7] We also believe that these goals are in the long-term best interests of the SROs. We address each of these goals in greater detail below.

1. Independence of Regulatory Functions

FIA has previously observed that "there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses."[8] The most effective means for strengthening the independence of the regulatory functions is by focusing on SRO governance. In order to strengthen the independence of regulatory functions, the independence of SRO board members, *vis-à-vis* the current composition of SRO boards, should be strengthened.

In the Position Paper, FIA outlines a critical reform necessary to address our concerns about conflicts of interest. Specifically, a "Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities."[9] This reform, along with others outlined in this letter, should minimize the risk that an SRO could use its regulatory authority for inappropriate purposes, or fail to use it in necessary circumstances.

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[7] *See also* Sections 5(d)(1), 5c(d), and 8a of the Act, as well as §1.64, Appendix B to Part 38, §38.5§, and 40.6. Section 5c(a)(1) provides that "the Commission may issue interpretations or approve interpretations submitted to the Commission, of section 5(d) [exempt boards of trade], 5a(d) [core principles for registered derivative transaction execution facility] and 5b(d)(2) (*sic*)[correct statutory reference is section 5b(c)(2)) derivatives clearing organizations] of this title to describe what would constitute an acceptable business practice under such sections." This letter is devoted primarily to governance of SROs that are designated contract markets ("DCMs"). However, in light of these provisions of the Act, FIA believes that its observations should apply with equal force to SROs other than contract markets to the extent that the same issues arise with respect to those SROs.

[8] Position Paper at I.

[9] Position Paper at I.

FIA continues to have concerns about some definitions of "independent director." As FIA observed in the Position Paper, it is not convinced that current exchange and others' definitions of "independent" are adequate to achieve these objectives. Some current standards define "independence" merely as not having a relationship with the SRO as an entity. At a minimum, FIA believes that independent directors should not be currently active in the industry or too recently associated with an SRO member

In addition, the independent board committee should have direct and unfettered access to information to ensure that it is making fully informed decisions. Further, it should have the ability to retain independent outside counsel in appropriate circumstances. Finally, FIA believes that the nomination process for independent directors of SROs should be free of management or member influence. Accordingly the nominating committee for the independent SRO board supervisory committee should be comprised only of independent individuals who meet the requisite independence test for directors.

FIA believes that, consistent with Core Principles 14-16[10], the Commission should use its authority to require SROs to implement the reforms outlined above and to ensure continued compliance. These changes would ensure greater independence of the board generally and the key committee described above to screen out inappropriate appearances of bias or conflicts. As a consequence, the changes would help SROs achieve the goal of greater independence of the regulatory function.[11]

2. Separation of Marketplace and Regulatory Functions

A second aspect of any reform must focus on ensuring an effective separation of an SRO's marketplace and regulatory functions. If an SRO is allowed to "commingle" its marketplace and regulatory functions, both an incentive and a potential exist for the SRO to use its regulatory functions to promote its marketplace or the pecuniary interests of its owners.

To enhance the independence of an SRO's regulatory functions, FIA believes that, at a minimum, functional separation of compliance and business staffs is necessary. Compliance and surveillance staff should report to the independent board committee. Those who manage the business unit of an SRO should not play any role in supervising compliance and surveillance staff. If the SRO contracts out any regulatory function, the independent contractor still should not report to business managers. Any other structure creates conflicts of interest and undermines the recommended separation and the role of the independent board committee.

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[10] The Commission issued an adopting release interpreting the Core Principles. 66 FR 42256 (Aug. 10, 2001). The Commission could consider further interpretations of the Core Principles to ensure that SROs are satisfying Congress's objectives in the CEA, as amended by the CFMA.

[11] FIA also notes that it believes industry members of SRO committees, including boards of directors, should include a broad representation of different constituencies. For example, in certain instances it would not be appropriate for disciplinary committees to exclude certain segments of the futures industry. *See* discussion below.

Consistent with the Position Paper, the committee of independent directors should have responsibility for:

- reviewing regulatory budgets;[12]
- ensuring adequate staff and resources;
- hiring, firing, and compensation of compliance and surveillance staff;
- achieving the requisite degree of separation of compliance and surveillance staff from other SRO staff;
- assessing and reviewing the performance of the self regulatory programs; and
- otherwise overseeing all aspects of the exchange's institutional regulatory functions.

3. Transparency of Regulatory Process/Ability to Participate in Process

A third aspect of any reform must enhance the transparency of the regulatory and disciplinary processes and protect the ability of a broad cross-section of the industry, including FCMs, to participate in these processes. Except where there are overriding concerns of confidentiality, SROs should make their own internal structures and processes transparent to outsiders.

Rulemaking

The rules[13] that an SRO adopts and the manner in which it enforces them are critical to complying with the core principles and, as important, to properly meeting its responsibilities as an SRO. Among other requirements, section 5(b) of the Act, which sets out the criteria for designation as a contract market, imposes on DCMs the obligation to adopt and enforce rules (1) to ensure fair and equitable trading, (2) to ensure the financial integrity of transactions entered into by or through the facilities of the DCM, (3) to prevent market manipulation, and (4) to discipline members or market participants that violate such rules. To both enhance the quality of SRO rulemaking and engender confidence in the SRO rulemaking process generally, the procedures by which a DCM adopts and enforces these rules should be transparent and should assure that members and other market participants, not just one constituency, have an opportunity to express their views and otherwise participate in the process.[14]

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[12] Disciplinary fines should not be taken into account in setting budgets. Fines that are collected should be dedicated solely to enhancing the contract market's regulatory activities or expanding professional and customer education.

[13] For purposes of this comment letter, the term "rule" has the same meaning as set forth in Commission Rule 40.1.

[14] The ability of market participants to have a role in developing the four categories of rules referenced above is particularly important, since they are most directly affected by such rules. In this regard, it generally would not be acceptable if such rules were developed solely by SRO staff and approved by the independent directors of the exchange or independent members of a committee.

Neither the Act not the Commission's rules prescribe the procedures that an SRO should follow in adopting rules. Nonetheless, we believe the essential elements of these procedures are implied in Part 40 of the Commission's rules. In particular, Commission Rules 40.5(a)(1)(v) (voluntary submission of rules for review and approval) and 40.6(a)(3)(iv) (self-certification of rules) each require a DCM to "describe any substantive opposing views expressed with respect to the proposed rule that were not incorporated into the proposed rule."[15] Further, Commission Rule 40.5(a)(1)(iv) requires an SRO, in submitting a rule for approval, to include in its submission, an explanation the operation, purpose and effect of the rule, including, as applicable, a description of the anticipated benefits, any potential anticompetitive effects, and how the rule fits into the framework of self-regulation.[16] We submit that an SRO cannot comply with the provisions of these rules—and the Commission cannot properly determine whether the SRO's rules violate applicable core principles, including the requirement that the SRO endeavor to avoid adopting any rule that results in an unreasonable restraint of trade or imposes any material anticompetitive burden on trading[17]—unless the SRO's rulemaking procedures are designed to solicit input from members and affected market participants on significant rule proposals.

As noted, to date the Commission has offered little direct guidance to DCMs in meeting this responsibility. We are not yet prepared to state that formal guidance pursuant to section 5c(a) of the Act is necessary. As an initial step, the Commission should request each SRO to submit for the Commission's review the written procedures by which the SRO develops and adopts rules. Only following this review should the Commission consider whether it would be appropriate to provide guidance to SROs in this area. The Commission's Part 40 rules could provide the foundation for the Commission's review and any guidance it may subsequently elect to issue.

We recognize that the Commission's rule review procedures are not the subject of this request for comment.[18] Nonetheless, the procedures by which an SRO adopts its rules and the procedures by which the Commission reviews such rules are inextricably linked.

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[15] Rule 40.5(a)(1)(v); Rule 40.6(a)(3)(iv) is similar.

[16] Although an SRO is not required to include such a written explanation in self-certifying a rule pursuant to Rule 40.6, we fail to see how an SRO could certify that the rule complies with the Act and the Commission's regulations unless it prepared such a document for its own files and for consideration by the board or appropriate committee prior to the adoption of the rule. Further, the board's committee of independent directors, recommended above, should have the responsibility to make any such certification, whether mandatory or voluntary.

[17] Section 5(d)(18) of the Act.

[18] However, then-Chairman James Newsome noted his view that review of Commission procedures and SRO procedures should occur together. "In this regard, just as I think it's important for the Commission to review our own regulatory structure, I also believe it's equally necessary for SROs, in consultation with us, to do the same." Address by Chairman James E. Newsome of the U.S. Commodity Futures Trading Commission at the Futures Industry Association Law and Compliance Luncheon Chicago - May 28, 2003, http://www.cftc.gov/opa/speeches03/opanewsm-40.htm

In addition, to the extent that affected market participants are not afforded an opportunity to have their views taken into account when an SRO adopts rules, FIA believes they must have the opportunity to seek redress with the Commission. Transparency in the Commission's consideration of SRO rules and the opportunity for public participation in this process is no less important than in an SRO's adoption of such rules. In appropriate circumstances, a request for comment should be published in the *Federal Register* as well as on the Commission's website, and the public should be afforded a reasonable amount of time to analyze the rules and prepare comments. The Commission's decision with respect to such rule, including its analysis of the comments, received should also be made available to the public.[19] FIA urges the Commission to implement the changes described with respect to both the processes at the SROs and its own oversight function.

Disciplinary Process

Conflicts of interest and other problems can impair the fairness and efficacy of the current SRO disciplinary process. FIA notes that narrowly drawn industry participants currently dominate many hearing panels. Consequently, peers judge peers and competitors judge other competitors. In addition, when one class of market participant dominates a disciplinary panel, other classes of market participants subject to the panel's disciplinary review may perceive the process to be unfair.

For these reasons, FIA recommends several reforms to the disciplinary process. Perhaps most importantly, neither the industry as a whole nor a particular industry segment should dominate disciplinary panels. However, it is important to recognize that industry participants can play a valuable role on a more balanced panel, particularly when the industry participant does not represent an industry segment that competes against the segment employing the person or entity charged. Industry participants can provide a "reality check" and industry knowledge to

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[19] An example of the importance of such procedures is the Commission's consideration of the Chicago Board of Trade and the Chicago Mercantile Exchange rules implementing the clearing link between these two exchanges. The exchanges submitted these rules pursuant to Commission Rule 40.5. Despite the fact that these rules significantly affected the rights and obligations of Chicago Board Trade clearing members and their customers, they were developed and adopted with little or no input from affected members. Yet, the Commission afforded market participants only three business days to analyze and prepare comments on the rules. As troubling, the Commission allowed itself less than one day to consider the comments that were filed before voting to approve the rules. Notwithstanding comments that raised what many considered significant questions of law, the Commission did not publicly address these questions in approving these rules.

Another example is the New York Mercantile Exchange's ("Nymex's") proposed amendments to rule 9.23, Protection of Clearing House. As the Commission is aware, as initially approved by the exchange, this rule would have significantly altered the purpose of the clearing house guarantee by authorizing the use of the Guaranty Fund and other Clearing House assets in certain instances to make whole the non-defaulting customers of a defaulting clearing member. The Nymex board approved this rule without adequate consultation with all affected clearing members of the exchange. After learning of the amendments, the members were able to convince the board to withdraw the rule amendments before they were submitted to the Commission. However, if the amendments had been submitted to the Commission, there would have been no apparent procedures by which affected market participants could have requested Commission review.

independent panelists. Furthermore, including panelists from the same industry segment as the person or entity charged can help guard against the possibility that panel members may not know enough about the behavior to judge it properly or worse, may want to punish a competitor from an alternative market.

However, FIA recognizes that including people from the same industry segment creates the risk that a panel may impose sanctions that are too light — protecting a friend; hoping that the competitor will remember the favor if roles are reversed in the future — or conversely, may impose sanctions that are too harsh — punishing a direct competitor. To address these concerns, FIA recommends the following reforms: (i) the independent committee of the board should appoint disciplinary panels; (ii) as noted in the Position Paper[20], disciplinary panels should be made up of a majority of knowledgeable independent panelists; (iii) industry members who represent a fair cross section of the industry should augment the panels[21]; (iv) at the request of non-industry panelists, the disciplinary panel should be able to seek the views of independent experts; and (v) aggrieved persons or entities should have the right to appeal to the full committee of independent directors or to a panel comprised solely of such independent committee members.

4. Preventing Unauthorized Disclosure of Confidential Information

A fourth aspect of any reform must focus on ensuring the confidentiality of information. The absence of confidentiality protections compromises other goals outlined above: independence of the regulatory function; separation of marketplace and regulatory functions; and transparency of/participation in the regulatory process.

Currently, SRO committees and in some cases the entire board of directors review disciplinary records and settlements, which may reveal confidential information. Industry personnel should not be able to use for commercial advantage information about a competitor that they obtained as a result of their service on an SRO committee or board of directors. Similarly, marketing and business staffs should never be permitted to use information obtained in their regulatory or compliance functions for business purposes. To limit the number of people who become privy to confidential proprietary information, therefore, FIA recommends that SROs modify their processes to ensure that only independent board members, relevant committees, such as business conduct and financial compliance, if applicable, and regulatory staff have access to such information.[22] The more people who know confidential information, the less the likelihood is that the information will remain confidential.[23]

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[20] Position Paper at II.

[21] *See* discussion below concerning confidentiality of information.

[22] As discussed above, we also recommend that the business and marketing staffs of an SRO be functionally separate from the regulatory and compliance staffs.

[23] In our June 18, 2004 letter to the Commission on the proposed revisions to the Joint Audit Agreement, we noted that the Commission had "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-

FIA recognizes that SROs have generally adopted codes of conduct, which include a provision prohibiting any person involved in the SRO process from disclosing or taking commercial advantage of confidential proprietary information obtained in the course of SRO activities. All such codes should be transparent and publicly available. Further, SROs should require their board members, staff, and outside consultants to sign such codes before undertaking SRO responsibilities.[24]

Conclusion

FIA appreciates this opportunity to comment on SRO governance. If the Commission has any questions concerning the comments in this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Sharon Brown-Hruska, Acting Chairman
Honorable Walter L. Lukken, Commissioner

Division of Market Oversight
Richard A. Shilts, Acting Director
Steven B. Braverman, Deputy Director
Rachel Berdansky, Special Counsel

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regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures." FIA endorsed the Commission's request and urged the Commission to make any information submitted by the SROs publicly available. To date, neither the SROs nor the Commission has released any information in this regard.

[24] The Position Paper recommends that "the FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions." The Position Paper explains that "given the number of exchanges that have SRO and DSRO responsibility, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges." Position Paper at IV. We suggest that the development and review of codes of conduct for confidentiality and other purposes could be the first such project.

EXHIBIT A

CFTC Study of Self-Regulation
Position Paper of the FIA
June 8, 2004

Summary

FIA supports the important role that exchanges and clearing houses perform as self-regulatory organizations (SRO) and designated self-regulatory organizations (DSRO). Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure.

FIA believes there is merit in the existing structure worth preserving and that more extreme alternatives are not desirable and are less efficient. Nevertheless, the existing structure can be improved through greater transparency and oversight that will minimize any potential conflict of interests. To be fully effective, there must be an increased degree of confidence in the integrity and objectivity of the SRO. We believe that specific modifications to the SRO structure can increase its overall efficiency and effectiveness. In addition, a clear delineation of the role and responsibility of the CFTC in proactively overseeing these SRO functions will enhance SRO performance and public confidence in the SRO structure.

The CFTC has been progressing with its review of the effectiveness of self-regulation in the futures industry. To facilitate this review, FIA has prepared this Position Paper to highlight key areas of concern in the hope that the CFTC will recognize the merits of these positions and take them into account in its assessment and recommendations for change in SRO responsibilities. In this regard, there are four broad issues that FIA recommends the CFTC address in its SRO Study. For each of these issues, FIA provides recommendations for specific changes to current SRO structures.

I. **Potential Conflict of Interests - There should be a division between the business and SRO/DSRO functions of exchanges and clearing houses.**

The exchanges provide a public good and public service through price discovery and a well-defined marketplace yet there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses. This problem potentially is exacerbated by demutualization and the move to for-profit structures. FIA recognizes that shareholders of for-profit structures are motivated in the long run to ensure market integrity and their failure to do so should ultimately reduce revenues and profit; however, there may be times when specific events will override the longer-term objectives of the exchange.

Recent legislative and regulatory actions against public companies, including the enactment of the Sarbanes-Oxley Act, suggests that without specific safeguards for-profit companies may not always act in the public interest. The possibility that exchanges or clearing houses can abuse their SRO responsibilities to the detriment of market participants and the public good cannot be dismissed. FIA believes that a more formal separation between the business and SRO functions of exchanges and clearing houses is essential to overall marketplace integrity. In that regard, we have the following recommendations.

- **A Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities.**

FIA recommends that each exchange/clearing house have such a Board Committee of independent, non-industry directors and that the Committee have the responsibility to oversee the SRO/DSRO budget, hire and fire compliance staff, ensure adequate staff and resources, review cases, audit SRO/DSRO performance and otherwise oversee all aspects of the SRO/DSRO function. In addition, it is absolutely critical that there be a definition of "Independent" that avoids any appearance of bias, conflict or any lack of independence. FIA is not convinced that current exchange and others' definitions of "independent" are adequate in these regards. In addition to being independent, these directors should not be currently active in the industry.

- **The Board Committee should be responsible to the CFTC for its oversight of the SRO/DSRO functions**

Like independent audit committees of public company boards under Sarbanes-Oxley, this Board Committee should have real accountability. Its activities, its responsibility for the budget and the audit all should be reviewed by the CFTC at least annually.

- **There should be a more formal separation between the business and compliance/surveillance staffs of exchanges and clearing houses.**

Compliance and surveillance staff should report to the Board Committee. They should not be involved in the business activities of the exchange or clearing houses and should not be in a supervisory chain that includes managers on the business side of the exchange or clearinghouse. To the extent the SRO function is contracted out, it still should not report to business managers. Any other result creates conflicts of interest and undermines the recommended separation and the role of the independent Board Committee.

II. **Appearance of Bias – A majority of the members judging proceedings should be disinterested parties.**

FIA recognizes that its concerns about SRO fairness will be reduced with the adoption of its recommendation of Board Committees of independent, non-industry directors overseeing SRO/DSRO functions. However, additional measures must be taken to address

related issues of fairness and confidentiality and to ensure SRO decision-makers will be independent of business pressures. In particular FIA is concerned that disciplinary panels dominated by peers judging peers has an inherent appearance of bias. Equally, disciplinary panels consisting of only one category of market participant can be seen as unfair especially from the viewpoint of other categories of market participants subject to the panels' disciplinary review. Market participants are entitled to a fair hearing. In this regard, FIA has the following recommendations.

- **A majority of the members of disciplinary panels should be made up of knowledgeable independent panelists.**

While FIA respects the experience and judgment of interested panel members, an appearance of fairness and the avoidance of bias are enhanced when a majority of disciplinary panel members are independent. Consideration should be given to permitting parties subject to discipline to request panels made up entirely of independent members.

- **Interested parties should not review the records of disciplinary proceedings and settlements.**

Currently, exchange committees and in some cases the entire Board of Directors reviews disciplinary records and settlements. These records reveal confidential information that should not be shared with competitors or other interested parties. The use of independent committees and the Board Committee of independent directors should address this problem.

III. **Enhanced Transparency – The CFTC should establish clear standards for DSROs and the allocation of firms among them.**

The efficiencies of the DSRO approach are widely recognized. At the same time, providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function. The CFTC should establish clear standards for qualification as a DSRO including a process to approve new providers wishing to perform financial compliance audits. Each of these providers should be subject to periodic CFTC review of their DSRO functions. This oversight should include detailed review of DSRO audits. A mechanism should be established to make the choice of DSRO cost neutral to exchange members. Subject to CFTC adopted standards, a member firm should be able to change its DSRO within the narrow band of CFTC pre-approved providers.

IV. **Sound Practices – The FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions.**

Given the number of exchanges that have SRO and DSRO responsibilities, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges. These sound practices should follow the model of core principles in the

Commodity Futures Modernization Act. In particular, directors who serve on the independent Board Committee with oversight responsibilities over SRO and DSRO activities should be trained to apply these industry-wide sound practices.

Conclusion

FIA believes that this is an ideal opportunity to improve a process that has largely been successful but may have certain conflicts and biases. FIA's hope in raising these issues and making these recommendations is to promote a dialogue that will lead to a fairer and more efficient SRO structure for the futures industry.

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June 18, 2004

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: Futures Market Self-Regulation, 69 *Fed.Reg.* 19166 (April 12, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the proposed revisions to the Joint Audit Agreement to be entered into among the several self-regulatory organizations ("Proposed Agreement").[25] FIA supports the important role that exchanges and the National Futures Association ("NFA") perform as self-regulatory organizations ("SROs") and designated self-regulatory organizations ("DSROs").[26] Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, as explained in detail below, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure that would be ratified in the Proposed Agreement.

Before addressing specific aspects of the Proposed Agreement, however, FIA notes that the Commission recently issued a *Federal Register* release requesting comment on a series of questions relating to the structure and governance of self-regulatory organizations. 69 *Fed.Reg.* 32326 (June 9, 2004). The latter release, which was issued in connection with the Commission's review of SROs, requests comment on such matters as the composition of boards of directors, issues arising from different forms of ownership, regulatory structure,

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[25] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

[26] Pursuant to Commission rule 1.3(ee), an SRO is defined as a designated contract market or a registered futures association. A DSRO is defined under Commission rule 1.3(ff) as an SRO assigned responsibility for monitoring and auditing an FCM in accordance with a plan approved under Commission rule 1.52. Significantly, designated clearing organizations are not self-regulatory organizations under the Commission's rules.

including the structure of disciplinary committees, and potential conflicts of interest generally. FIA recently filed with the Commission a position paper outlining several broad areas of concern in this area and will be preparing a more detailed response to this release.[27]

In our view, the Commission's review of the Proposed Agreement cannot be considered separately from the Commission's more general review of SROs. Certainly, FIA's comments below might well change depending on the Commission's response to our broader concerns. Therefore, we recommend that the Commission defer any decision with respect to the Proposed Agreement until its SRO study is complete.

A Changed Industry

The derivatives industry has undergone significant change in the twenty years since the original Joint Audit Agreement was entered into in 1984 and, in particular, in the years following enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"). Legal uncertainty surrounding over-the-counter ("OTC") derivatives transactions among qualified eligible participants has been resolved, and a burgeoning OTC market in swaps and other derivatives instruments both competes with and complements the exchange traded markets.[28] Many FIA member firms, either directly or through affiliates, are active participants in the OTC derivatives markets. Concurrently, the clearing divisions of the Chicago Mercantile Exchange ("CME") and the New York Mercantile Exchange ("Nymex") both offer to provide clearing facilities for OTC derivatives.

Moreover, exchanges have entered into direct competition with each other. BrokerTec Futures Exchange and, more recently, the U.S. Futures Exchange ("USFE"), an indirect subsidiary of Eurex Frankfurt AG, have challenged the Chicago Board of Trade's ("CBT's") dominance in futures on US Treasury instruments, leading the CBT to counter by offering futures on the German Bund, Bobl and Schatz.[29] Meanwhile, Euronext.Liffe recently began offering futures on Eurodollars, in direct competition with the CME.

Finally, not all clearing organizations are as tied to futures exchanges as they once were. The CBT has terminated its relationship with The Clearing Corporation and has been clearing transactions through the CME since late 2003.[30] The Clearing Corporation now provides

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[27] Letter to James Newsome, Chairman, from John M. Damgard, President, FIA, dated June 8, 2004.

[28] The International Swaps and Derivatives Association ("ISDA") estimates that, as of December 31, 2003: (1) the notional principal outstanding volume of interest rate derivatives, which include interest rate swaps and options and cross-currency swaps, was $142.31 trillion; (2) the notional value of outstanding credit derivatives, including credit default swaps, baskets and portfolio transactions was $3.58 trillion; and the outstanding notional value of equity derivatives, consisting of equity swaps, options, and forwards, was $3.44 trillion.

[29] As a result of its purchase of BrokerTec Futures Exchange, several of the larger FCMs own a significant interest in USFE.

[30] The Clearing Corporation, of course, has always been an independent legal entity.

clearing services for USFE and other exchanges. In addition, the London Clearing House has been approved as a designated clearing organization ("DCO"), but does not yet provide clearing services for any designated contract market ("DCM"). Although not represented on the Joint Audit Committee ("JAC"), independent clearing organizations have a clear and undeniable interest in the financial integrity of member FCMs.[31]

As the above summary indicates, the derivatives industry is anything but static. More important, the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement. Further, we submit that the Proposed Agreement should provide the flexibility necessary to accommodate the inevitable changes the industry will experience in the years ahead.

Voting Eligibility

Paragraph 3 of the Proposed Agreement provides that "[o]nly those Parties which were members of the JAC prior to the year 2000 or which conduct their own auditing activities as a DSRO (rather than subcontracting such responsibilities) shall be eligible to vote." Neither the Proposed Agreement nor the *Federal Register* release requesting comment explains the reasons underlying this provision. On its face, it appears to have no rational basis.

What regulatory purpose is served by granting voting privileges to AMEX Commodities Exchange and the Philadelphia Board of Trade, neither of which currently list products for trading, while denying voting privileges to USFE? Certainly, the distinction cannot be based on the decision of USFE to subcontract certain of its self-regulatory responsibilities to NFA. A review of the Commission's *Selected FCM Financial Data* as of May 31, 2004, indicates that, with a few exceptions, DSRO responsibilities are performed by only three self-regulatory organizations—CBT, CME and NFA.[32] Without further explanation, the provisions of paragraph 3 relating to voting eligibility appear to have no purpose but to assure the continued dominance of the "old exchanges" over the "new exchanges."

Under the Commodity Exchange Act ("Act"), all DCMs have self-regulatory obligations that they are required to meet. Further, although the Act clearly contemplates that DCMs may delegate these obligations to a registered futures association, such as NFA, or another

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[31] As noted in footnote 2 above, DCOs are not self-regulatory organizations under the Commission's rules. Nonetheless, DCOs have an obvious interest in the financial integrity of their member FCMs. Therefore, procedures should be developed to assure that DSROs provide independent DCOs the same access to financial and other relevant information obtained by a DSRO with respect to a member FCM as the DSRO now makes available to DCOs that are divisions of a DCM. In addition, consideration should be given to inviting independent clearing organizations to participate, if not vote, in meetings of the JAC.

[32] Of the 178 registered FCMs: NFA is the DSRO for 97 FCMs; the CBT is the DSRO for 40 FCMs; the CME is the DSRO for 29 FCMs; Nymex is the DSRO for 10 FCMs; and the Kansas City Board of Trade and New York Board of Trade are the DSRO for one FCM each.

registered entity, the Act also provides that that DCM "shall remain responsible for carrying out" these obligations.[33] As long as a DCM has statutory self-regulatory obligations that it is required to meet and, consequently, may be held responsible for the manner in which a DSRO performs these obligations on its behalf, FIA believes that each DCM should have an equal voice in matters that become before the JAC.[34]

Allocation of Firms Among DSROs

As noted earlier, the CBT, CME and NFA serve as the DSROs for essentially all registered FCMs. Further, either the CBT or the CME is the DSRO for all but two of the twenty largest FCMs by amount of segregated funds held.[35] FIA is not concerned that these three entities perform the majority of DSRO activities on behalf of other DCMs. To the contrary, particularly in the area of financial audits, we believe that the expertise demanded of audit staff effectively requires that these responsibilities be exercised by a small number of qualified SROs. Nonetheless, two aspects of the Proposed Agreement cause concern.

First, the Proposed Agreement provides no means by which an FCM may participate in the selection of its DSRO. In addition, once assigned to a DSRO, an FCM may not be reassigned, except with the consent of that DSRO. As we discussed at the outset of this letter, exchanges and their FCM members are increasingly engaged in activities that appear to compete with each other. Consequently, an FCM may find that its activities are being audited by an exchange that is, or at least appears to be, its competitor. In these circumstances, and in order to avoid even an appearance of a conflict of interest, an FCM should have the ability to change its DSRO.[36]

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[33] Section 5c(b) of the Act.

[34] Paragraph 3 of the Proposed Agreement also provides:

> If two or more Parties become commonly owned through a merger or acquisition, the surviving Party is entitled to one representative on the JAC; provided, however, that any Party which maintains a separate legal entity after an acquisition, will retain their representative on the JAC.

FIA agrees that, if two or more DCMs become commonly owned, they should be entitled only to one representative and one vote on the JAC in all instances. The fact that a DCM is maintained as a separate legal entity following an acquisition should not entitle that entity to representation or a vote.

[35] Based on the Commission's *Selected FCM Financial Data* as of May 31, 2004, these twenty firms hold in excess of 85 percent of all customer segregated funds. Of these firms, the CBT is the DSRO for 12, the CME is the DSRO for six and Nymex is the DSRO for two.

[36] We want to be clear that we are not asserting that any DSRO has acted, or would act, in a way that would constitute a conflict of interest. Nor would we anticipate any rush by FCMs to change their DSRO. To the contrary, in our discussions with FIA member firms, they are by and large satisfied with the DSRO to which they have been assigned. Nonetheless, as we noted in our June 8, 2004 position paper on self-regulation, "providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function."

We have considered various means by which an FCM could be permitted to change its DSRO and suggest that an FCM should be able to change its DSRO on a periodic basis, *e.g.*, every five years.[37] The FCM could request this change for any or no reason. Although an FCM could participate in the selection of its DSRO, the FCM would not have the unilateral right to choose the DSRO that would assume responsibility for the firm. Rather, the DSRO would be chosen from among those SROs that the Commission has determined meets clear and objective standards. Any procedure should assure and prevent any appearance that the FCM was engaging in regulatory arbitrage among DSROs.[38] Separately, FIA believes the Commission should establish procedures in rule 1.52 by which an FCM may petition the Commission to request a change in the FCM's DSRO in the unlikely event that the DSRO has engaged in egregious misconduct conduct with respect to the FCM.

Second, we believe that the exchanges should not have the unquestioned right of first refusal with respect to the allocation of DSRO responsibilities among exchange member firms. As discussed above, in light of the potential appearance of conflict of interests between an FCM and its DSRO, FIA believes that procedures should be considered to permit NFA or another non-exchange entity to serve as an FCM's DSRO, *provided* that entity meets Commission approved standards.

Confidentiality

The information that DSROs obtain in the course of their examinations of member firms and the records they prepare obviously contain confidential proprietary and business information that an FCM would not otherwise disclose. FIA is concerned that the confidentiality provisions set forth in paragraph 8 of the Proposed Agreement do not provide sufficient assurance that such information will not be shared with other divisions of the DSRO or with other SROs except for appropriate cause. Since FCMs are not parties to the Proposed Agreement and otherwise appear to have no cause of action against an SRO that may improperly disclose confidential information, it is particularly important that the responsibilities of SROs in this regard be clearly circumscribed.[39]

In a press release dated February 6, 2004, the Commission announced that it has "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-

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[37] No FCM, however, would be required to change its DSRO under this procedure.

[38] As noted in our June 8 position paper, FIA believes that a mechanism should be established to make the choice of DSRO cost neutral to exchange members.

[39] Again, FIA is not asserting that the audit staffs of any exchange or other SRO have inappropriately shared otherwise confidential business information.

regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures."[40]

Consistent with the Commission's recommendations, FIA respectfully submits that the Proposed Agreement governing confidentiality of FCM proprietary and business information should be revised to describe specifically the limitations on the use of such information. In addition, FIA believes the Commission should consider adopting a rule requiring the confidential treatment of all proprietary and confidential information collected during an examination. Such a rule would assure that violations of FCM confidentiality would be subject to appropriate penalty.

Commission Review

In light of the constant change that is the hallmark of the derivatives industry and the potential conflicts of interest that are inherent in any self-regulatory structure, FIA encourages the Commission to play a more active role in overseeing the activities of the Joint Audit Committee.

Conclusion

FIA appreciates the opportunity to submit these comments on the Proposed Agreement. If you have any questions concerning this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable James E. Newsome, Chairman
Honorable Walter L. Lukken, Commissioner
Honorable Sharon Brown-Hruska, Commissioner

Division of Clearing and Intermediary Oversight
James L. Carley, Director
Thomas J. Smith, Associate Director

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[40] FIA supports the Commission's request that SROs examine their policies and procedures designed to protect the confidentiality of member information and make these policies and procedures public. FIA is not aware that any SRO has responded to the Commission to date. We recommend that this information be made publicly available as soon as possible in order to afford FIA and others an opportunity to submit comments in response to the Commission's June 9, 2004 *Federal Register* release.

QUESTIONS AND ANSWERS

MARCH 8, 2005

Responses to Follow-up Questions for the Record submitted by Chairman Saxby Chambliss from March 8, 2005 Committee on Agriculture, Nutrition and Forestry hearing to consider the reauthorization of the Commodity Futures Trading Commission, for Dr. James Newsome, President, New York Mercantile Exchange (NYMEX).

1. **Question: What is the relationship, if any, to price volatility that has been observed in the last several years in natural gas markets and the passage of the Commodity Futures Modernization Act of 2000?**

The passage of the Commodity Futures Modernization Act of 2000 (CFMA) bears no relationship to the underlying market dynamics of any specific commodity, or to price movements or volatility in any given market. The CFMA, a landmark legislative achievement, has allowed the futures industry to operate in an environment of legal certainty and regulatory flexibility, by moving away from prescriptive regulations to a framework of core principles[1] (see Attachment 1) designed to ensure market integrity, orderly markets, and customer protection. The CFMA has been a positive development for all of the commodity futures markets and it has allowed markets to operate more efficiently and to better meet the needs of their customers.

The price moves observed in the natural gas market in recent years and most notably in 2004 are a clear product of significant and fundamental shifts in the supply-demand balance. Natural gas has re-emerged as a critical component of the nation's energy resource mix since deregulation. Rapidly increasing demand for this commodity has eroded virtually all excess capacity that had previously existed and, at peak demand, strains the nation's distribution infrastructure. This phenomenon was noted in the NYMEX report on hedge fund participation submitted to the Committee for the record.

It should also be noted that an increase in price also increases the effect of market volatility. For example, if a market's volatility is measured at 20%, the effective price movements will be greater at higher prices.

In competitive markets, where prices are determined by supply and demand factors, the general cause of price volatility is the uncertainty about the future relationship between these factors. The very tight balance currently existing between supply and demand is likely to continue until demand subsides or until there is a greater level of certainty in the market that an adequate supply and/or distribution capacity will exist to meet periodic spikes in demand.

[1] Commodity Exchange Act Section 5(d).

2. **<u>Question</u>: If it is true that the natural gas market operates most effectively when the price for natural gas is shaped by supply and demand fundamentals, please describe the impact on the price discovery process of imposing narrow daily price limits on natural gas futures markets.**

"Daily price limit" is defined by the CFTC as the maximum price advance or decline from the previous day's settlement price permitted during one trading session. Price limits, by their very nature, are arbitrary, and consequently can lead to artificial results. For instance, price limits can impede the price discovery process because when the high or low limits are reached, the futures market is prevented from trading at market-clearing prices—it will lock at the price limit. Nonetheless, the underlying cash-market and related over-the counter derivatives markets are not artificially constrained so the end result would be to disconnect the futures market from the other markets with which it both interacts, and is intended to serve.

This is problematic for several reasons. First, it would means that the marketplace that is intended to be the most transparent would provide false information—the futures price would not reflect true price discovery in the market because it would be prevented from trading at the actual price. Second, the futures market would be prevented from serving as a hedge, or risk management tool, for cash market and derivative transactions—one of the essential functions of futures markets—because it is prevented by the limit from moving in step with these transactions. Third, futures market participants would be impaired because they would be unable to adjust their positions in response to changing market conditions—they would be trapped in their market positions until the limit was no longer binding.

The unavoidable conclusion is that when price limits artificially bind futures markets, they can cause harm, which is doubly damaging given that futures markets are relied upon for providing a higher level of protection and service to market participants than underlying cash or derivative markets. In light of this potential, NYMEX has adopted temporary price-halts in place of price-limits in its most volatile markets. These are especially appropriate for more volatile markets, which benefit most from the transparency and hedging opportunities that futures markets provide. Temporary halts give market participants opportunity to communicate with customers, brokers and off-exchange counterparties to evaluate market conditions and corresponding responses for when the futures market re-opens.

The greatest disservice an Exchange can perform, both to its customers and to the public, is to stop functioning as a marketplace. Binding price limits do just that at precisely the moment the market most needs a dependable, transparent marketplace—when prices are moving sharply and quickly. A price limit that is too narrow to allow for normal market fluctuation (which varies by market based on its dynamics of supply, demand, and certainty) sacrifices transparency and hedging opportunities at critical moments when industry, consumers, and the larger economy are most in need of accurate price signals and risk management.

3. Question: Please discuss the relationship (if any) of price volatility to the susceptibility of a market to manipulative practices.

While there are many scenarios under which an analysis can be made, it is the Exchange's view that in the context of natural gas markets there is no relationship between price volatility and susceptibility of the market to manipulation. Though the Exchange does suggest that manipulations are actually taking place in any specific markets, the opportunity to attempt manipulation would be greater in markets that are thinly traded and lack competition. The natural gas futures market, on the other hand, is highly competitive, since at any given point in time there are hundreds of participants are actively engaged in trading.

The Exchange conducts market surveillance on a continuous basis throughout each trading session and is confident in the competitiveness of the natural gas futures market, both during times of relative price volatility and stability. We have concluded that, if anything, volatility has tended to attract participants into the market. When more participants engage the market, either as hedgers seeking price certainty or as speculators seeking greater reward for capital at greater risk— then the market becomes deeper and more robust. Such an environment is hardly prone to manipulation. Further, any entity that would attempt to manipulate markets through the use of market power would put themselves at greatest risk in volatile markets. If such an attempt fails, their exposure to loss is far more.

There is neither evidence nor indication that would suggest that any commodity markets have been manipulated. All inquiries by CFTC, GAO, and by NYMEX's independent compliance department, both in recent months and in years prior, have concluded that the regulated markets were operating fairly. It should be noted that this has also been the case when inquiries were made into "low" prices, due to concern by producers.

The integrity of NYMEX markets is of paramount importance to the Exchange and its regulatory program has received publicly disseminated favorable Rule Reviews by the CFTC. Self regulatory organizations (SROs) such as NYMEX have demonstrated their seriousness about pursuing and eliminating the potential for any entity to influence the market and have been effective in taking action when any issues have arisen.

4. Question: Please explain why the number of commercials trading natural gas have declined in recent years.

The collapse of Enron and similar entities in 2001 and later resulted in a large number of displaced market participants whose market activity under the energy merchants had previously been categorized as "commercial." Since the dissolution of the energy merchant sector, many of these same entities continued to participate in the market through other kinds of funds that do not fall under the category of commercial entities – although as market makers they continue to serve an essential commercial function.

NYMEX trade data show that there have been significant shifts in market share since the end of 2001. In that time, which coincides with the collapse of the energy merchant model, the role of market maker in the wholesale market has shifted from companies that were active in the transport of natural gas to companies that specialize in trading and risk management using derivatives (including regulated futures and options). As the role of market maker shifts to different types of entities, commonly referred to as "funds" or "hedge funds," it may appear to some that activity in the markets has shifted from commercial to non-commercial. Since swap dealing has long been considered to be a commercial activity, it is the Exchange's view that there has been no real decline in the number of commercials trading natural gas in recent years. Moreover, a number of companies organized as hedge funds, which may thus be viewed in some quarters as "non-commercial," have established the wherewithal to make and take delivery of the underlying physical commodity, further supporting the positive role provided by such companies to the market, as well as the commercial value of their activities.

If one measures the overall level of activity in the market place by commercials and non-commercials, it is clear that there was less overall trading volume in the marketplace in the years 2003 and 2004 relative to 2002. However, volumes seem to be steadily increasing in recent quarters in all sectors (exchange and OTC) and among all types (commercial and non-commercial), signifying a more robust and healthy marketplace.

5. Question: Is it an appropriate analogy to compare energy commodities such as natural gas to agricultural commodities and therefore to regulate them in the same manner? If not, why not?

The CFMA applies the market safeguards articulated in the core principles uniformly across all products listed by a futures exchange, including energy, metals, agricultural, and other commodities. Thus, the general market protections monitored and enforced by a futures exchange do not vary by product. On the other hand, the CFMA did make one distinction between the regulation of agricultural commodities and energy commodities. Specifically, all exchanges can self-certify changes to all futures contracts terms and conditions except for changes to contracts for delivery of agricultural commodities in contracts already listed for trading that have open interest. NYMEX believes that the flexible regulatory structure implemented under the CFMA for exchange-traded energy products has worked well. In particular, the ability to self-certify rule changes to contract terms and conditions has proven to be an efficient means of responding promptly to the business needs of the exchange trading community. The experiences of U.S. futures exchanges with the self-certification process has demonstrated that the ability to self-certify has not resulted in any regulatory problems.

That stated, there are fundamental differences in the general market characteristics of agricultural and energy products. For example, the supply-demand relationship for agriculture products that offer a renewable supply and numerous choices for product substitution is not analogous to those for energy products that do not have these

characteristics. Thus, an approach that automatically equates agriculture and energy products as having identical market characteristics is overly simplified.

6. Question: Should all futures changes in the rules regarding natural gas futures contracts be subject to prior CFTC approval and to public comment?

When the Congress passed the CFMA in 2000, it determined that a structure of core principles was preferable to the prescriptive command-and-control regulatory regime and would best serve the futures industry without compromising the integrity of the markets or the public interest. The flexibility provided by the CFMA has allowed new contracts to be offered expeditiously, and has facilitated changes to existing contracts that allow them to be matched as closely as possible to constantly evolving industry standards. Self-certification allows this to occur in a timely manner while maintaining strict compliance with the core principles. Changes to contracts are infrequent; however it is essential to be able to respond quickly when industry changes do occur, or where innovation can better meet customer needs.

As an SRO, NYMEX is required to provide CFTC with notice of any changes to its contracts per the self-certification process set forth in the CFMA. As a matter of policy, NYMEX is in close communication with CFTC at all times, and in general provides the CFTC with notice of intent to self-certify a rule change well in advance of the change, in order to ensure that any changes strictly meet the requirements set forth by Congress. All changes are subject to CFTC review and oversight, and must be pre-approved at the Exchange by stakeholder representatives through an established SRO committee process that includes approval by the relevant product committee, Executive Committee, and Board of Directors. Additionally, the CFTC may stay the effectiveness of a rule self-certification pending a formal proceeding for filing a false certification or to alter or amend the rule.

On NYMEX, each product committee consists of customer representatives, a broad diversity of market participants, and research staff with product expertise. A process that required public comment on all rule changes, many of which are highly specialized contract specification changes that impact a very specific market segment, would not further the public interest, but rather would impede the regulated exchanges from making timely business decisions. The committee process as it exists ensures that business decisions can be made in a timeframe that meets the demands of a competitive business environment, while ensuring that stakeholder interests are protected.

The Congress has designated the role of CFTC as providing oversight to ensure that the core principles set forth by the Congress in the CFMA are met. NYMEX complies fully with the core principles, and proactively consults with the CFTC to ensure that any steps taken are within the scope of the CFMA. There would be no justification for the cost and time burden of legislating a new prior approval process where notification, in conjunction with CFTC consultation, is already achieving the desired regulatory ends.

7. **<u>Question</u>: It has been suggested that the CFTC should have "back-up" authority to impose additional requirements concerning large position reports. Please comment on the necessity and advisability of such a legislative change.**

The CFTC already has authority under Section 8a(7) of the Act:

> ***"to alter or supplement the rules of a registered entity as necessary and appropriate by rule or regulation or by order ... for the protection of persons producing, handling, processing or consuming any commodity traded for future delivery on such registered entity ... or for the protection of traders or to insure fair dealing in commodities traded for futures delivery on such registered entity. Such rules, regulations or order may specify changes with respect to such matters as – (A) terms or conditions in contracts of sale to be executed on or subject to the rules of such registered entity; ... ."***

This broad authority clearly would allow the CFTC to impose additional requirements on an exchange concerning large position reports. Procedurally, the CFTC would request that the registered entity effect the changes on its own behalf, but if the exchange does not make the required changes, the CFTC can do so by formal action.

8. **<u>Question</u>: Finally, please describe the advisability of a legislative change under which the CFTC would have the authority to mandate that a natural gas contract that is currently closed by physical delivery would be required to be restricted to cash settlement.**

Legislation that could require a physically deliverable contract be restricted to cash settlement would be highly unadvisable for several reasons. First, such a mandate would undermine the symmetrical relationship between physically delivered and cash settled markets, which, in a functioning market will necessarily reach convergence as a physical contract approaches its expiration ("due") date. Thus, the physical delivery mechanism facilitates the ability of a futures market to converge with and thereby to reflect the "true" price of the commodity with respect to the physical marketplace.

Second, such a mandate would harm the integrity of the natural gas market by reducing or eliminating participation by the commercial market participants who value the physical delivery provided by the futures contract and do take physical delivery of the product from the futures market. Commercial participants make up an important segment of a futures market, where diversity of market participants is vital to an efficient, effective market. Diversity of market participants is a stabilizing factor in markets. In a homogenous market, prices will be more volatile since more participants will tend to behave in the same way at the same time.

Attachment 1

CORE PRINCIPLES FOR CONTRACT MARKETS
As set forth in Section 5(d) of the Commodity Exchange Act

(d) Core principles for contract markets

(1) In general

To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.

(2) Compliance with rules

The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

(3) Contracts not readily subject to manipulation

The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

(4) Monitoring of trading

The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.

(5) Position limitations or accountability

To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

(6) Emergency authority

The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority

to--

(A) liquidate or transfer open positions in any contract;

(B) suspend or curtail trading in any contract; and

(C) require market participants in any contract to meet special margin requirements.

(7) Availability of general information

The board of trade shall make available to market authorities, market participants, and the public information concerning--

(A) the terms and conditions of the contracts of the contract market; and

(B) the mechanisms for executing transactions on or through the facilities of the contract market.

(8) Daily publication of trading information

The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

(9) Execution of transactions

The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.

(10) Trade information

The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.

(11) Financial integrity of contracts

The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

(12) Protection of market participants

The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.

(13) Dispute resolution

The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.

(14) Governance fitness standards

The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).

(15) Conflicts of interest

The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest.

(16) Composition of boards of mutually owned contract markets

In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.

(17) Recordkeeping

The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.

(18) Antitrust considerations

Unless necessary or appropriate to achieve the purposes of this chapter, the board of trade shall endeavor to avoid--

(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or

(B) imposing any material anticompetitive burden on trading on the contract market.

Questions for Sharon Brown-Hruska (Ranked in Order of Priority)
Submitted by Senator Harkin

CFTC Oversight of Excluded Derivatives (Basically, Financial Derivatives, i.e. OTC interest rate or treasury note products).

Chairman Brown-Hruska, It has long been a central feature of the futures regulation in this country that there are significant elements of the futures market completely excluded from CFTC jurisdiction—particularly financial swaps. The theory behind this has always been that these markets are restricted to sophisticated market participants who deal directly with one another. Therefore they are responsible for managing their own risk.

But don't recent financial scandals show that any market is subject to potential manipulation, fraud or abuse? And don't these scandals have irreparable consequences often times for consumers and the public? Even in the absence of a scandal the potential fallout to the public if major banks, insurers, pension plans, health-care providers, or other enterprises were to fail from derivatives trading misjudgments seems substantial and worthy of attention.

Response:

All markets, or for that matter any business activity, have the potential for becoming venues for manipulation, fraud and other types of abuses. At the same time, the CFTC and other financial market regulators (i.e., the Federal Reserve, SEC, OCC and Treasury), as well as the exchanges themselves, oversee these markets in order to minimize these abuses. While there have been instances of abuse, the record suggests they are relatively rare.

Derivative markets serve an important function in the economy in that they provide a means for businesses and individuals to transfer unwanted risks to those who are willing to accept them for a price. Knowledgeable use of derivatives to manage preexisting risks can help mitigate the potential of some types of business failures, and can help reduce the risks faced by the public who may rely on these businesses for their products or their livelihoods.

The question of potential failure of certain kinds of enterprises (e.g. pension plans, insurers, etc.) resulting from derivatives trading is a concern. However, derivatives should not be singled out from other financial instruments for special attention on this basis. This is because business losses are not confined to derivatives trading. Misjudgments in the use of any financial instrument can lead to large business losses. Derivative contracts are simply neutral risk management tools that can be used either wisely or unwisely. Moreover, to the extent that enterprises are subject to regulation by another regulatory agency, such as an insurance, pension fund or banking regulator, those agencies are situated to monitor the overall business activities of their regulatees.

Now that the CFMA has been in effect for over four years, do the members of the President's Working Group on Derivatives (CFTC, SEC, Dept. of Treasury, and the Federal Reserve) have among them the authority to police these markets? More importantly, are they using their authorities?

Response:

In its November 1999 report, the President's Working Group on Financial Markets (PWG) recommended changes to the Commodity Exchange Act (CEA) intended, to among other things, (1) remove the cloud of legal uncertainty overhanging U.S. OTC derivatives markets; (2) promote innovation, competition, efficiency, liquidity, and transparency in those markets; (3) reduce systemic risk; and (4) maintain U.S. leadership in those rapidly-developing OTC derivatives markets. With respect to CFTC authority over financial swaps in "excluded commodities" (the interest rate, financial, currency, and index products listed in Section 1a(13) of the Act), the PWG recommended creating an exclusion from the CEA for: (1) bilateral swaps between eligible contract participants (ECPs—the sophisticated traders described in Section 1a(12) of the Act); and (2) electronic trading systems that limit participation to certain ECPs trading principal-to-principal for their own accounts. Through the CFMA, these recommendations were incorporated into the CEA as Sections 2(d)(1) and 2(d)(2) respectively.

The PWG's rationale for these exclusions was that : (1) OTC derivatives in excluded commodities are not generally subject to manipulation because they are "settled in cash, based on a rate or price determined by a separate highly liquid market with a very large or virtually unlimited deliverable supply;" (2) the sophisticated counterparties that use OTC derivatives "simply do not require the same protections under the CEA as those required by retail investors;" and (3) most swaps dealers, in any event, "are either affiliated with broker-dealers or FCMs that are regulated by the SEC or the CFTC or are financial institutions that are subject to regulation by the SEC or the CFTC or are financial institutions that are subject to regulation by bank regulatory agencies," and thus their activities are "already subject to direct or indirect federal oversight."

The regulatory authority available to the PWG member agencies under existing law appears to be appropriately tailored and effective. The staffs of the agencies engage in regular meetings, on a biweekly and monthly basis, to share information on the markets. In addition, when necessary, the staffs heighten that contact when particular activity of concern warrants such attention. The Commission's experience has been that the agencies have been able to pool their information and resources to satisfactorily deal with these situations.

Should the CFTC be given the authority to monitor the activities of large market participants in excluded commodities to reduce the risk of market disruption or systemic economic loss?

Response:

As in the previous response, most large OTC dealers in contracts based on excluded commodities, i.e., financial instruments, are overseen by bank regulatory agencies or the SEC, do not involve retail participants, and have a minimal probability of market manipulation. To back away from the principles of the CFMA and implement a system of monitoring large OTC market participants would be a difficult challenge, since most OTC swaps are executed bilaterally, away from any central marketplace, and transaction information would have to be separately gathered from widely-scattered market participants. In addition, since most of these transactions are not standardized, configuring any transaction data into a meaningful form would be costly and of questionable use to any market oversight effort. In my view, the minimal benefits to be gained from an OTC reporting system would be far outweighed by the costs to industry to comply with reporting requirements and to taxpayers to fund the significant additional resources the CFTC would need to develop such a reporting and surveillance system. Any proposal to implement such a system of reporting and surveillance would have to take into consideration the substantial additional resources that would be required to modify the CFTC's current surveillance system, which is designed to oversee a centralized marketplace in which standardized contracts are traded. It should be noted that, when warranted, CFTC surveillance staff is able to gather information on participants' positions in other markets, including the cash and OTC derivatives markets to ascertain whether violations of the CEA or CFTC rules exists. In this sense, the CFTC already has the authority to monitor the activities of large market participants.

CFTC Authority over Energy Transactions

I understand that the CFTC and FERC have brought several enforcement cases regarding illegal activities in the energy markets, but what I want to know is how Federal agencies can do a better job of preventing abuses in the energy derivatives markets. Surveillance and continuous oversight are a hallmark of successful programs that detect and address abuses early. How can the CFTC do this for exempt commodities such as energy or metal derivative products? How can we obtain more transparency and openness in the energy markets?

Response:

The successful record of the CFTC with respect to the futures markets that it oversees is in part due to the structure of those markets. Futures contracts are traded on centralized exchange markets and traded in standardized units and terms, thus making it possible, without imposing significant costs on participants, to aggregate and report positions to the Commission for surveillance purposes. Moreover, the Commission's surveillance program is primarily set up to detect manipulations that involve the buildup of cash and futures positions at specific delivery points—i.e. squeezes and corners.

By contrast, the over-the-counter markets for exempt commodities often involve decentralized markets involving non-standardized contracts and diverse delivery points. In view of this and because the contracts generally are entered into to meet real commercial requirements without a buildup of positions (open interest) that would exceed actual supplies, these markets tend to be less susceptible to delivery point squeezes and corners. By the nature of the contracts, it is much more difficult to aggregate contracts into meaningful positions. Where the Commission has brought actions with respect to manipulation in the natural gas markets, the problems were related to the reporting of false information regarding trades and prices. These abuses were not detected through the traditional surveillance program of the Commission, but rather were revealed through the course of investigating conducted by the CFTC's Division of Enforcement. As described on the next page, the Commission has taken action against the offending parties and has imposed significant fines for their behavior.

In general, the best way to promote more transparency and openness in the energy markets is to encourage the development of liquid marketplaces. Manipulation becomes a particular concern when the price generated on a marketplace is broadly used to set prices for a commodity. When prices are set in liquid markets, manipulation tends to be less of an issue, because of the existence of many participants with competing knowledge and interest who can discipline the price discovery process. The competition to develop such liquid markets also encourages the markets to promote openness so as to attract more participants to their platforms.

Your testimony indicates that the CFTC has levied over $300 million in fees in its various energy cases. How much of that has the CFTC actually collected?

Response:

To date, $240 million of the approximately $300 million in penalties assessed in connection with the Commission's enforcement of violations of false reporting, attempted manipulation and manipulation in the energy markets has been deposited with the United States Treasury.

The companies and individuals the Commission has brought actions against and the assessed penalty in each case is as follows:

Energy Enforcement Actions – Settled

1. *In re Dynegy Marketing and Trade, et al.*, Docket No. 03-03 (Filed Dec. 18, 2002) (settled; $5 million civil monetary penalty);
2. *In re El Paso Merchant Energy, L.P.*, Docket No. 03-09 (Filed March 26, 2003) (settled; $20 million civil monetary penalty);
3. *In re WD Energy Services Inc.*, Docket No. 03-20 (Filed July 28, 2003) (settled; $20 million civil monetary penalty);
4. *In re Williams Energy Marketing And Trading, et al.*, Docket No. 03-21 (Filed July 29, 2003) (settled; $20 million civil monetary penalty);
5. *In re Enserco Energy, Inc.*, Docket No. 03-22 (Filed July 31, 2003) (settled; $3 million civil monetary penalty);
6. *In re Duke Energy Trading And Marketing, L.L.C.*, Docket No. 03-26 (Filed Sept. 17, 2003) (settled; $28 million civil monetary penalty);
7. *In re CMS Marketing Services and Trading Company, et al.*, Docket No. 04-05 (Filed Nov. 25, 2003) (settled; $16 million civil monetary penalty);
8. *In re Reliant Energy Services, Inc.*, Docket No. 04-06 (Filed Nov. 25, 2003) (settled; $18 million civil monetary penalty);
9. *In re Harmon*, Docket No. 03-25 (Filed Jan. 16, 2004) (settled; $8,500 civil monetary penalty);
10. *In re Aquila Merchant Services, Inc.*, Docket No. 04-08 (Filed Jan. 28, 2004) (settled; $26.5 million civil monetary penalty);
11. *In re ONEOK Energy Marketing And Trading Company, L.P., et al.*, Docket No. 04-09 (Filed Jan. 28, 2004) (settled; $3 million civil monetary penalty);
12. *In re Entergy-Koch Trading, LP*, Docket No. 04-10 (Filed Jan. 28, 2004) (settled; $3 million civil monetary penalty);
13. *In re Calpine Energy Services, L.P.*, Docket No. 04-11 (Filed Jan. 28, 2004) (settled; $1.5 million civil monetary penalty);
14. *In re e prime, Inc.*, Docket No. 04-12 (Filed Jan. 28, 2004) (a wholly-owned subsidiary of Xcel Energy, Inc.; (settled; $16 million civil monetary penalty);
15. *In re Knauth*, Docket No. 04-15 (Filed May 10, 2004) (settled $25,000 civil monetary penalty);
16. *In re Western Gas Resources, Inc.*, Docket No. 04-17 (Filed July 1, 2004) (settled; $7 million civil monetary penalty);

17. *CFTC v. Enron Corp., et al.*, No. H-03-909 (S.D.Tex. filed March 12, 2003) (settled with respect to company, Enron Corporation - $35 million civil monetary penalty; *CFTC v. Hunter Shively,* No. H-03-909 (S.D. Tex filed March 12, 2003) (settled with respect to individual defendant, Hunter Shively - $300,000 civil monetary penalty);
18. *In re Coral Energy Resources, L.P.*, Docket No. 04-21 (Filed July 28, 2004) (settled; $30 million civil monetary penalty);
19. *In re Biggs*, Docket No. 04-22 (Filed Aug. 11, 2004) (settled; $30,000 civil monetary penalty);
20. *In re BP Energy Co.,* Docket No. 05-02 (Filed Nov. 4, 2004) (settled; $100,000 civil monetary penalty);
21. *In re Cinergy,* CFTC Docket No. 05-03 (CFTC filed November 16, 2004) (settled; $3,000,000 civil monetary penalty);
22. *In re Mirant,* CFTC Docket No. 05-05 (CFTC filed December 6, 2004) (settled; $12,500,000 civil monetary penalty); and
23. *CFTC v. American Electric Power Company, Inc., et al.*, No. C2 03 891 (S.D.Ohio filed Sept. 30, 2003; settled January 26, 2005) (settled; $30,000,000 civil monetary penalty).

Retail Forex

The case of CFTC v. Zelener seems to provide a template for how to avoid CFTC regulation not just of retail foreign exchange, but possible for any futures contract. Given the difficulty of obtaining legislative fixes, isn't this an area that Congress must address during reauthorization—since we may not have another chance for years? Is it acceptable to the CFTC to have uncertainty regarding its authority in an area rife with abuse as retail foreign exchange? Does the CFTC have any suggestions for how to address the Zelener case? Should Congress fix this apparent loophole for all retail derivatives transactions?

Response:

It is correct that the *Zelener* decision could be applied to any futures contract, not just to retail foreign currency (forex) contracts. Foreign currency, though, is the area in which we have seen the most problems. The existence of boiler room operations that fraudulently guarantee large returns on forex contracts with little or no risk to the capital invested continues to be a serious national problem. While we disagree with the outcome in the *Zelener* case, and believe most other courts would have ruled in a different way, *Zelener* does not foreclose the possibility that the CFTC may succeed in asserting jurisdiction over *Zelener*-type contracts by introducing evidence that the right to offset was implied or guaranteed during the solicitation process.

The Seventh Circuit in the *Zelener* case arguably departed from the precedent of other circuits, and its own precedent, by rejecting the multi-factor inquiry that had traditionally been used to distinguish between futures and forwards, and focusing instead on contractual fungibility and the availability of offset. But that departure related more to the methodology for determining whether a contract is a futures contract, than to whether the contracts at issue are, indeed, futures. The right to offset is a necessary element of a futures contract under both *Zelener* and the traditional multi-factor approach. That common element provides the basis for our view that we can prevail in these types of cases under either approach as long as we can establish that element through extrinsic evidence. *See CFTC v. Co Petro Mktg. Group, Inc.*, 680 F.2d 573, 580 (9th Cir. 1982) (contract that does not contain standardized terms can still be considered a futures contract if the seller "implicitly guarantees" that it will provide for offset).

Although *Zelener* does not preclude the possibility that the Commission may succeed in asserting jurisdiction over *Zelener*-type contracts in the future under the right set of circumstances, the Commission is seeking Congressional support to strengthen CFTC authority to prosecute unscrupulous purveyors of fraudulent futures and options schemes who prey on the retail public. The Commission is consulting representatives of various segments of the futures and derivatives industries and the National Futures Association, as well as the members of the President's Working Group on Financial Markets, in an effort to arrive at a consensus recommendation for legislative language that would address the *Zelener* decision. We will submit a specific legislative proposal that will appropriately clarify our enforcement powers in this area in the near future.

Fraud and Anti-Manipulation

Nearly three years ago, then-Chairman Jim Newsome, Commissioner Tom Erickson, and members of this Committee had a discussion about the CFTC's anti-fraud and anti-manipulation authority. As you know, there is still debate about whether that authority applies to over-the-counter energy derivative products.

Response:

The CFMA represented a landmark effort to balance the need of regulators to safeguard financial integrity with the need of markets to be free of over burdensome regulation. The CFMA enables the CFTC to address misconduct and anomalies in the marketplace by means of regulatory oversight and enforcement intervention and avoids having undue regulation stifle financial transactions and innovation involving sophisticated market participants. To date, the balance seems to be working well, and has enabled the CFTC to react decisively to events in the marketplace, such as the rampant false reporting in the energy trading area.

Importantly, Section 2(h) of the Commodity Exchange Act (CEA) already affords the CFTC anti-fraud and anti-manipulation authority over exempt commodity agreements, contracts and transactions—including those involving energy. Further, Section 9(a)(2) of the CEA affords the CFTC the ability to pursue manipulation and attempted manipulation relating to energy and multiple other commodities. Also, as explained in the next response, the Commission clearly has the authority to bring actions involving any commodity for attempted or actual manipulations of prices regardless of whether the transactions occur over the counter or on an exchange.

We continue to believe that, with the slight statutory modification that we are recommending to Section 4b to clarify the "for or on behalf of" issue, the answer today is much the same one that Congress applied in enacting the CFMA—little or no such systemic risk or public interest is apparent in the swaps markets at this point that would necessitate a legislative reversion to an older model of prescriptive and expensive regulation. The proposed change to Section 4b would clarify that the Commission has fraud jurisdiction over transactions in exempt contracts, as Section 2(h) clearly envisioned, even where the parties are trading on their own behalf, rather than—as Section 4b currently states—"for or on behalf of another person."

Should Congress make clear that the CFTC's anti-fraud and anti-manipulation authority applies to all exempted derivative products such as energy and metal derivatives?

Response:

As discussed in the previous response, the Commission has clear authority to pursue actions against would-be manipulators of the energy and metals markets. As an example of this authority, the Commission charged twenty-seven companies and nineteen individuals for wash trading, false reporting, attempted manipulation and/or manipulation. Of the individuals and companies that challenged the Commission's authority under the Act, a handful made the argument that the conduct in question was beyond our statutory grasp by virtue of its relationship to transactions in exempt commodities that fell largely outside the jurisdiction of the Commission by reason of exemptions and exclusions under Section 2(g) and 2(h) of the Act. As the factual scenarios in all energy matters the Commission pursued, and as enunciated by the federal courts to have ruled on the subject, price reporting to industry publications and attempted manipulation are activities that do not further the execution or completion of energy contracts, and in many instances, is conduct that occurs even in the absence of actual contracts. Therefore, the exemptions and exclusions introduced by the CFMA do not seem to controvert the Commission's ability under the Act to pursue manipulation violations and promote market integrity through enforcement actions.

With respect to the Commission's antifraud authority over exempted derivatives products, Section 2(h) of the Act preserves the agency's authority to bring fraud claims. The Commission's antifraud authority under Section 4b of the Act, however, appears not to extend to transactions that embody principal-to-principal relationships as are contemplated in Section 2(h). To close this loophole, the Commission has consulted with the Senate and House staffs of the agriculture and energy committees and reached a consensus on language that has been placed into the Energy Policy Act of 2005 that recently passed in the House of Representatives. This language would make clear that under Section 2(h) of the Act, where the Commission's antifraud authority has been preserved, the Commission could pursue fraud claims that involve transactions entered into under a principal-to-principal relationship. The Commission will include the suggested language from the energy bill in its recommendation of statutory language to the Senate and House agriculture committees.

Self Regulation

Do you believe that the self-regulatory aspects of the CFTC's current system are working adequately to protect the public? Are there any lessons you have learned since the passage of the CFMA? Does the CFTC need to set out greater guidance for the industry regarding SRO activities to ensure the openness, transparency, and independence of SRO functions carried out by exchanges or industry associations?

Response:

I believe that the self-regulatory aspects of the CFTC's oversight program serve well to protect the public interest. In that regard, the Commission maintains a comprehensive rule enforcement program to ensure that exchanges comply with the Commission's regulations and adhere to the core principles applicable to them under the Act. This program involves periodic rule enforcement reviews of exchange compliance programs. These reviews result in the issuance of public reports containing staff findings and recommendations with respect to the adequacy of an exchange's overall compliance capabilities in light of the core principles applicable to the exchange. The reviews generally include an evaluation of an exchange's trade practice surveillance, audit trail, market surveillance, disciplinary, dispute resolution, and governance programs. In addition, the Commission conducts direct oversight of daily exchange trading activity and reviews records of trades to detect potential trading violations for referral to the pertinent exchange or to the Commission's enforcement division. The Commission also conducts routine floor surveillance to detect and deter trading violations.

With respect to setting out greater guidance for the industry regarding SRO activities, Commission staff undertook an extensive review of self-regulation in the futures industry. That review is nearing completion. The review was not driven by any self-regulatory failures, but rather by the Commission's desire to determine whether the existing self-regulatory model continues to be effective given increased competition, new ownership structures and evolving business models in the industry. The staff's preliminary conclusions are that: (1) the existing self-regulatory model is working adequately and can continue to provide fair, vigorous and effective self-regulation that protects market integrity, industry participants and the public; (2) industry developments may result in new or increased conflicts of interest that should be addressed proactively; and (3) to address those potential conflicts, SROs may need to insulate their regulatory functions from their commercial interests and possible improper influence.

The staff's preliminary recommendation with respect to these findings involve the adoption of guidance, via the issuance of new acceptable practices under the Commission's core principle that addresses the management of conflicts of interest in exchange governance and regulatory matters.

Hearing on Reauthorization of the Commodity Futures Trading Commission
Committee on Agriculture, Nutrition, and Forestry
U.S. Senator Rick Santorum
March 8, 2005

Questions for Sharon Brown-Hruska, Acting Chairman, Commodity Futures Trading Commission

Question 1: ***Since butter and cheese are storable commodities, there is a direct link between the CME cash market for cheese and butter and CME futures markets for Class III milk and butter. When daily cash prices rise, futures prices in the outer months change in the same direction. If this is the case, isn't the behavior of the cash market also a direct concern of the CFTC?***

Response:

Yes, because the CME's cash markets for cheese and butter do have a significant influence on prices of the CME's futures contracts for class III milk and butter, the performance of these cash markets is of concern to the CFTC. As described more fully in response to question 3, the Commission's market surveillance staff closely monitors the CME's futures and cash markets for cheese and butter. In this regard, the staff is in regular contact with a broad spectrum of dairy market participants, including individual dairy farmers, co-ops, processors, and end users.

Question 2: ***Under current federal order prices, CME cash prices have a direct impact on all prices of milk and dairy product prices in the U.S. including prices at the farm, wholesale, and retail levels. The CME cash prices are used in the formulas that determine farm prices, and wholesale and retail prices are also directly affected. The retail value of milk and dairy products is around $75 billion a year in the U.S. Should the CFTC be concerned about possible manipulation of the CME cash and futures markets for dairy products?***

Response:

From mid-1995 through the end of 1999, CME's cash butter prices were input directly into the USDA's basic formula price (BFP) for determining milk prices. Although the USDA no longer directly inputs CME cash prices for butter into its formulas for determining milk prices, and has never directly input the CME cash prices for cheese into these formulas, it is clear that these markets are a major determinant of cash prices for dairy products. With this in mind, the Commission takes very seriously its responsibility to ensure that these markets are free of manipulation, and that the CME is doing its job to provide an open and competitive marketplace.

Question 3: ***Both the cash butter and cheese markets at the CME are thinly traded. Roughly one-half of the one percent of all cheddar cheese and six percent of all butter are traded each year on the CME, yet the CME directly affects $14 billion of the farm value of milk in the U.S. Are you concerned that there is an economic incentive for market price manipulation, manipulation that would also be reflected in dairy futures markets?***

Response:

Yes. One of the most important functions of the Commission is to work to ensure that markets are free of price manipulation. The Commission works to accomplish this with a two-fold approach: a market surveillance program that is designed to detect and prevent manipulation, and an enforcement program that investigates and, if appropriate, prosecutes cases of possible price manipulation. The Commission is aware that the CME's cash cheese and butter markets, although thinly traded, are very important as price discovery vehicles and that the prices on those markets are widely consulted by industry participants in the dairy industry. The Commission takes its anti-manipulation responsibility very seriously, and, as described below, it has devoted considerable resources to examining trading activity in the CME's cheese and butter markets.

In the past several years, our surveillance economists have conducted several special inquiries with respect to possible anomalies in the dairy market. These inquiries have examined the size and timing of individual traders' buying and selling in the spot markets and have included interviews of some major dairy industry participants. We have found that, although there are relatively small numbers of actual transactions, the spot butter and cheese call sessions are closely monitored by a number of commercial traders in various segments of the dairy industry who stand ready to participate if conditions warrant. This potential for participation by commercial traders in the dairy industry, by reacting to any perceived pricing anomalies, provides a significant check on manipulative activity. The Commission will continue to conduct vigilant surveillance of these markets, and will take appropriate enforcement action if we find evidence of price manipulation.

Hearing on Reauthorization of the Commodities Futures Trading Commission
Committee on Agriculture, Nutrition and Forestry
U.S. Senator Rick Santorum
March 8, 2005

Questions for Terrence Duffy, Chairman, Chicago Mercantile Exchange Holdings, Inc.

1). Since butter and cheese are storable commodities, there should be is a direct link between the CME cash market for cheese and butter and CME futures markets for Class III milk and butter. When daily cash prices rise, future prices in the outer months change in the same direction. Are you concerned that prices in the past have not reflected this direct link?

2). Under current federal order prices, CME cash prices have a direct impact on all prices of milk and dairy product prices in the U.S. including prices at the farm, wholesale and retail level. The CME cash prices are used in the formulas that determine farm prices and wholesale and retail prices are also directly affected. The retail value of milk and dairy products is around $75 billion a year in the U.S. Are you concerned about possible manipulation of the CME cash and futures markets for dairy products?

3). Both the cash butter and cheese markets at the CME are thinly traded. Roughly ½ of 1 percent of all cheddar cheese and 6 percent of all butter are traded each year on the CME, yet the CME directly affects $14 billion of the farm value of milk in the U.S. Are you concerned that there is an economic incentive for market price manipulation, manipulation that would also be reflected in dairy futures markets?

TO CONSIDER THE REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

THURSDAY, MARCH 10, 2005,

U.S. SENATE,,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SR–328A, Russell Senate Office Building, Hon. Saxby Chambliss, chairman of the committee, presiding.

Present or submitting a statement: Senators Chambliss and Salazar.

STATEMENT OF SAXBY CHAMBLISS, A U.S. SENATOR FROM GEORGIA, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

The CHAIRMAN. This hearing will come to order, and good morning.

We are here today to discuss the reauthorization of the Commodity Futures Trading Commission, which is set to expire in September of this year. CFTC is charged with the responsibility of overseeing the trading of commodities futures contracts, and the Commodity Exchange Act is the basic law that empowers CFTC to carry out this responsibility.

As part of the last CFTC reauthorization in 2000 Congress passed the Commodity Futures Modernization Act, making some substantial changes in the Commodities Exchange Act. The CFMA provided legal certainty for the over-the-counter swaps market and also streamlined the regulatory process for exchange, traded futures markets.

As we proceed into this reauthorization of the CFTC, the committee is hoping to learn not only how people view the changes made in 2000, but also what changes, if any, need to be made in future legislation.

This is the second hearing held by the committee on the subject of CFTC reauthorization, and I thank all the witnesses for appearing today to discuss this very important topic. We have already heard from the acting chairman of the CFTC as well as a group of people representing U.S. futures exchanges and the futures industry.

Today I would like to welcome representatives from the over-the-counter markets and others from across the industry. The committee looks forward to hearing your views on this reauthorization

process. We have with us today Mr. Jeffrey Sprecher, the CEO of InterContinentalExchange in Atlanta, Georgia; Mr. Robert Pickel, Executive Director and CEO of the International Swaps and Derivatives Association from New York; and Mr. Oliver Ireland, Partner with Morrison & Foerster here in Washington, DC, on behalf of Huntsman Chemical, a member of the Industrial Energy Consumers of America.

This will be our first panel, and gentlemen, we welcome you this morning. We have a number of other hearings that are ongoing this morning, including a very important hearing that affects this committee and that is the markup on the budget for fiscal year 2006, so we have a number of members who are absent as a result of that hearing and others.

I am advised that Senator Harkin will be running a little late getting here, but he will be here shortly. We are going to go ahead and proceed with opening statements from this first panel. Mr. Sprecher, we will start with you, then Mr. Pickel and then Mr. Ireland. We welcome you again. Thank you for being here. We look forward to your comments.

Mr. Sprecher.

STATEMENT OF JEFFREY C. SPRECHER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, INTERCONTINENTALEXCHANGE, ATLANTA, GEORGIA

Mr. SPRECHER. Thank you, Mr. Chairman.

My name is Jeff Sprecher, and I am the founder, the Chief Executive Officer and the Chairman of InterContinentalExchange, which in our industry is also known as ICE. ICE operates the leading global electronic over-the-counter marketplace for trading energy commodities and derivative contracts that are based on energy commodities. Energy commodities that are traded on our platform include oil, natural gas and power. ICE also operates an energy commodities futures exchange through a wholly owned London-based subsidiary called the International Petroleum Exchange of London, which is also known in the industry as the IPE.

I would like to thank the committee for its effective and far-sighted work in developing and adopting the CFMA. The CFMA has been critical to my company's success for three reasons. First, the CFMA provided legal certainty for OTC derivative contracts. Second, the CFMA created a new category of trading facility called the exempt commercial market. This committee recognized that electronic marketplaces whose participants are limited to eligible commercial entities, or ECMs, trading on a principal-to-principal basis do not require the same level of Federal oversight as futures exchanges that are accessed by the retail public. The CFMA also permitted the clearing of OTC transactions. Today ICE provides clearing for a variety of its OTC contracts, reducing unwanted credit exposure and increasing market liquidity.

As you mentioned, we are headquartered in Atlanta, Georgia and we operate a many-to-many electronic platform that allows buyers and sellers of physical commodities and derivative contracts to view and act on each other's bids and offers. ICE, unlike Enron with its EnronOnline, is not a party to any of the transactions on our platform. ICE's electronic platform is designed to enhance the trans-

parency, the speed and the quality of trade execution. In addition our platform offers a comprehensive suite of trading-related services including OTC electronic trade confirmation, access to clearing services and the publication and dissemination of market data and information.

As I stated earlier, ICE operates as an ECM under the jurisdiction of the CFTC. As an ECM ICE is required to comply with access, with reporting and recordkeeping requirements. ICE has worked closely with the CFTC since our inception and we look forward to continuing a cooperative relationship. We also look forward to working with this committee as it considers the many issues facing the CFTC during its reauthorization.

With respect to issues affecting ECMs in particular, ICE is of the view that the CFMA and the rules adopted by the CFTC provide for an effective framework for oversight of commercial marketplaces. There is no need to amend the Commodity Exchange Act in this area. The CFTC has promoted open, freely accessible and transparent markets including permitting the creation of ECMs. I believe that restricting trading activity through additional regulation would only adversely affect the market liquidity and price transparency and would not reduce price volatility that we have been seeing recently in energy.

On behalf of ICE I would again like to thank the committee for its excellent work in enacting the CFMA. It's been a clear benefit to my company, and I would submit, to the producers and the users of energy commodities around the world.

ICE looks forward to working with the committee during the reauthorization process, and at the appropriate time I will be happy to take your questions. Thank you.

[The prepared statement of Mr. Sprecher can be found the appendix on page 188.]

The CHAIRMAN. Great. Thank you.

Mr. Pickel.

STATEMENT OF ROBERT G. PICKEL, EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NEW YORK

Mr. PICKEL. Mr. Chairman and members of the committee, I appreciate your invitation to testify today on behalf of ISDA. ISDA has appeared frequently before the committee in prior years and we welcome the opportunity to be with you today as you continue your important hearings with respect to legislation to reauthorize the Commodity Futures Trading Commission.

ISDA is an international organization, and its more than 600 members include the world's leading dealers in swaps and other off-exchanged derivative transactions commonly referred to as OTC derivatives. ISDA's membership also includes many of the businesses, financial institutions, governmental entities and other end users that rely on OTC derivatives to manage risk inherent in their core economic activities effectively and efficiently. I am also happy to say that my two fellow panelists, their firms are also members of our organization.

The Commodity Futures Modernization Act was adopted by Congress with broad bipartisan support after careful consideration over several years by four congressional committees and with the support of the President's working group. The CFMA extended much needed regulatory relief for the futures exchanges, provided legal certainty and regulatory clarify for OTC derivatives, and removed the ban on the trading of single stock futures.

ISDA's principal interest in the CFMA was and remains with those provisions intended to provide legal certainty for OTC derivatives. The phrase "legal certainty" means simply that the parties to an OTC derivatives transaction must be certain that their contracts will be enforceable in accordance with their terms. The CFMA framework for providing legal certainty is based on a longstanding consensus among Congress, the CFTC and others that OTC derivative transactions are not appropriately regulated as futures under the CEA.

The legal certainty provisions of the CFMA were intended by Congress to reduce a systemic risk and promote financial innovation. Our experience since 2000 confirms that both of these objectives have been achieved. The use of OTC derivatives for risk management purposes has continue to grow both in periods of economic downturn and uncertainty and in times of economic expansion.

The reductions in systemic risk resulting from enactment of the legal certainty provisions of the CFMA have not come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since enactment of the CFMA. For example, the significant growth in credit default swaps to manage credit risk in times of volatility and uncertainty has been greatly enhanced by the legal certainty provisions of the CFMA. Similarly, the legal certainty provisions have encouraged dealers to develop and businesses to use an increasing range of new kinds of OTC derivatives such as weather derivatives to manage additional types of risk. Finally, the CFMA removed the regulatory barriers to clearing of OTC derivatives, and while collateralized transactions remain more prevalent, the emergence of alternative clearing proposals attests to the positive effects of the CFMA on financial innovation.

For these reasons ISDA shares the view expressed by Acting CFTC Chair Sharon Brown-Hruska that the CFMA functions extremely well. In our view this is attributable to the care with which Congress constructed the legislation, to the even-handed manner in which the CFTC has interpreted and administered the CFMA in accordance with congressional intent, and to the CFTC's vigorous enforcement program following the collapse of Enron and the California energy situation.

ISDA believes that the experience that its members and others have had under the CFMA demonstrates that there is no fundamental need for Congress to make substantive changes to those portions of the legislation governing OTC derivatives. ISDA is of course aware that others have advocated substantive changes to the legislation, including changes with respect to OTC derivatives. In our view, however, the case for such changes simply has not been made.

We understand that you and your colleagues will want to have the benefit of a full range of views concerning the CFMA. We think this is highly desirable and welcome the opportunity to participate constructively in the debate and discussion of possible changes. We do, however, urge you and your colleagues to proceed cautiously in reopening the CFMA. The legislation, although carefully crafted, is complex and the potential for unintended and undesirable consequences from selective changes is great.

We also urge you and your colleagues to ensure that your committee asserts fully its right and responsibility to review and approve any substantive changes to the CEA. Our experience in recent years has confirmed that the use of freestanding amendments offered to separate legislation without your committee's review, scrutiny and public comment is an undesirable method of considering changes to legislation as complex and important as the CEA.

Let me conclude, Mr. Chairman, with three observations. First, by providing legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the longstanding policies and the CFTC, the CFMA materially reduced systemic risk and encouraged financial innovation. Second, the regulatory relief provided to the futures exchanges has likewise provided substantial benefits to the capital markets. Together these two factors confirm that the policy judgments made in 2000 were sound then and remain so today.

Finally, ISDA remains available and is looking forward to working cooperatively and constructively with your committee, and we look forward to the opportunity to do so in the coming months.

I look forward to any questions you may have. Thank you.

[The prepared statement of Mr. Pickel can be found in the appendix on page 199.]

The CHAIRMAN. Thank you very much.

Mr. Ireland.

STATEMENT OF OLIVER I. IRELAND, PARTNER, MORRISON & FOERSTER, LLP, WASHINGTON, DC, ON BEHALF OF HUNTSMAN CORPORATION AND INDUSTRIAL ENERGY CONSUMERS OF AMERICA

Mr. IRELAND. Thank you, Mr. Chairman and members of the committee.

I am a partner in the D.C. office of Morrison & Foerster. I previously served as Associate General Counsel to the Board of Governors of the Federal Reserve System, and there advised the Board on matters relating to derivative transactions. I am here on behalf of the Huntsman Corporation, a member of the Industrial Energy Consumers of America. I thank you and the members of the committee for the opportunity to participate in today's hearing on CFTC reauthorization legislation.

Huntsman is a global leader in the chemical manufacturing business. Global manufacturing companies like Huntsman depend on the commodities markets for their materials and rely on fair pricing in those markets. A key commodity for Huntsman, as well as thousands of other domestic businesses and millions of farmers and consumers is natural gas.

While we generally believe that the Commodity Exchange Act as amended by the Commodity Futures Modernization Act of 2000

functions exceptionally well, price volatility in the natural gas contracts since mid 2000 suggest that the market for natural gas futures may not be operating efficiently, and that the regulatory framework for these contracts should be reviewed.

A price of natural gas that is shaped by fundamental forces of supply and demand will allocate the supplies of gas within the economy most effectively. Facilitating this pricing function is one of the key purposes of the Commodity Exchange Act. However, if this pricing process breaks down, that breakdown can result in inappropriate pricing and inefficient allocation of natural gas in the economy.

We believe that there is evidence that the level of price volatility in the futures market for natural gas is impairing, rather than promoting, pricing in the natural gas market. Since 2000 day-to-day price volatility in the natural gas futures contract traded on the NYMEX has increased substantially, even after taking into account the higher prices for natural gas during this period. By some measures price volatility in the natural gas contracts traded on the NYMEX has increased by 60 percent. During the same period commercial trading participants on the NYMEX have declined to a relatively small percentage of the market participants. We believe that this price volatility raises questions as to whether the trading in natural gas may be subject to inappropriate practices.

While the CFTC has responded to a number of unlawful acts in the markets for natural gas, we believe that the committee should consider four changes to the Commodity Exchange Act to augment the authority of the CFTC to address natural gas contracts.

First, we think that the committee should consider regulating natural gas under the Commodity Exchange Act under the same framework applicable to agricultural commodities.

Second, we believe that the committee should consider requiring the CFTC to review and seek public comment on and approve existing and new rules for natural gas contracts based on consistency with the core principles established in the Commodity Exchange Act. We believe that this process should focus particular attention on price fluctuation limits or circuit breakers. Circuit breakers can provide time for markets to evaluate new information and to act appropriately, therefore promoting price discovery. We believe that a circuit breaker more on the order of the 8 percent that was in effect prior to the year 2000 should be the benchmark and that circuit breakers above that level should be scrutinized carefully.

Third, we believe that the committee should consider giving the CFTC backup authority to require large position reporting where such reports are not otherwise being made. The CFTC should also be authorized to require recordkeeping to help police the reporting requirement. We recognize that these authorities should be used sparingly, taking into consideration the burden that they may impose as well as their utility in detecting or deterring inappropriate market practices.

Finally, we believe that the committee should consider giving special authority to the CFTC to address rules for settlement in the natural gas futures contracts, allowing for cash settlement where market manipulation is suspected, and thereby making short squeezes in the futures market more difficult.

Thank you for the opportunity to be here today, and I would be happy to address any comments or questions the committee may have.

[The prepared statement of Mr. Ireland can be found in the appendix on page 213.]

The CHAIRMAN. Thank you very much. Thanks to all of you.

Mr. Ireland, I will let you back up a minute and explain to my limited brain capacity this circuit breaker. Would you run through that one more time? I am not sure I followed you.

Mr. IRELAND. Many markets, including the futures markets, have what I refer to as a circuit breaker which when the price of trading reaches a certain level at variance with the previous trade's close, trading stops either for the day or for some period of time. For example, in the natural gas contract on the NYMEX up until early the year 2000 if the price moved 15 cents they stopped trading until the next day. That gives——

The CHAIRMAN. Which is what we refer to as limit up or limit down?

Mr. IRELAND. Limit up or limit down, the same thing. Similar provisions are in place in the equities market and were recommended by the President's working group on financial markets following the 1987 stock market break.

The CHAIRMAN. There is no such provision for natural gas is what you are saying?

Mr. IRELAND. Well, there is a provision today, but the dollar limit is I believe on the NYMEX $3, and that stops trading for 5 minutes, and then it resumes, and then it stops if it moves another $3. With the prevailing price of natural gas of about $6, that $3 trading limit, which restarts again so quickly, I do not think imposes any meaningful time for the market to catch up with new information.

The CHAIRMAN. Explain to me again what your thought is relative to what sort of regulatory measure ought to be established to control that.

Mr. IRELAND. We think that the CFTC should review each natural gas contract provision or exchange rule applicable to natural gas for consistency with the core principles. We believe that when the CFTC reviews those rules, as the current gas contract does provide for a trading limit greater than the pre-early 2000 number, which was about 8 percent, that that number ought to receive particular scrutiny and the Commission ought to affirmatively find, based on substantial evidence, that that number is not going to facilitate manipulation in the markets, and that that is consistent with the price discovery function of the exchange.

The CHAIRMAN. OK. Mr. Sprecher, we understand that ICE is an exempt commercial market under the CEA, and why are you not regulated in the same way as NYMEX?

Mr. SPRECHER. Thank you for your question. As an exempt commercial market, ICE is limited as to the participants that we can allow to use our system, and under the CFMA those participants are called ECEs, I believe, exempt commercial entities, but they essentially are companies with substantial knowledge and a substantial asset base. I believe a company must have at least $100 million

worth of assets, $10 million in net worth, and a substantial business in the industry to participate on ICE.

We are not allowed access—to allow participants to access our platform who are retail customers, unknowledgeable or small net worth companies, which is allowed in the futures industry, and we think the Modernization Act was very well crafted in recognizing that the Government does not need the same level of scrutiny to two large international oil companies doing business with one another as opposed to the broad access consumer-base marketplaces that are a part of the futures business.

The CHAIRMAN. Let me ask you about the comments of Mr. Ireland relative to this circuit breaker issue. You of course trade in energy contracts.

Mr. SPRECHER. Yes.

The CHAIRMAN. While you have this exempt status, I am certain that there obviously are times when you have interaction with CFTC relative to the contracts you utilize. Would you comment on his statement relative to this proposed control of the volatility, and also how you interact with CFTC relative to energy contracts that you have.

Mr. SPRECHER. Sure. I have a number of thoughts. First of all with respect to reauthorization, I have the view that the CFTC has a lot of tools in its capacity to make sure that markets run orderly and to make sure that there is no fraud or manipulation, and while I do not have a specific stake in the New York Mercantile Exchange, I am aware that exchanges in general have anti-fraud, anti-manipulation, and free and orderly market responsibilities as part of their charter and mandate to the CFTC. I do not know that the reauthorization needs to specifically address new language.

Now that being said, there is no question that natural gas has become a preferred fuel in our country because of its clean-burning efficiency and wide accessibility, and as such the market has become incredibly complicated with many users and gas moving around the country. The New York Mercantile Exchange trades a single contract that is delivered at the Henry hub in Louisiana. On the over-the-counter market, or in layman's terms, the non-exchange market, there are over 200 different delivery points for natural gas, and they are all woven together in a complex marketplace, and so while it might be beneficial to halt trading in one market to allow an orderly process, I think the reality is that there are these other markets that would continue to trade unabated, and you run the risk of essentially allowing sophisticated market participants or these ECEs that trade in the over-the-counter market to continue to trade and hedge during high volatility while the retail customer and the smaller participant who do not access these markets would essentially be trapped by an artificial price cap for a moment in time. I am not sure it is ultimately a workable solution given the complexity of our markets today.

The CHAIRMAN. Mr. Pickel, do you have a comment relative to that issue?

Mr. PICKEL. Not specifically on the recommendations that Mr. Ireland made. I would say that you have here represented on the panel the range of activity. You have comments regarding an actual exchange, the NYMEX. You have the perspective of the ECM

in ICE. Then you have the perspective that ISDA brings to the issues, which is the privately negotiated sector where parties will enter into a transaction on a bilateral basis typically governed by a contract that we have published and developed over the years, and again, under the CFMA those transactions are excluded from the CEA in recognition that those transactions are typically done between sophisticated parties. They negotiate a contract and agree to their own protections in that contract, and it is really only those two parties who are aware of the terms of that particular contract, as distinct from an exchange where that price gets published and is available on screens on a running basis, and also information regarding the trading on ICE that can also be obtained by those people who are participating in that marketplace.

The CHAIRMAN. Would your customers' transactions not have an influence on the price of natural gas on NYMEX, for example?

Mr. PICKEL. The transaction itself, no, I do not think those would serve that price discovery function. Now, the parties may in turn go and look to lay off some of their exposure either on the NYMEX or on ICE or some other market that might be available, and to the extent that those activities trigger concerns from a manipulation standpoint, the protections and the authorities that the CFTC has would apply, but with respect to those activities, not with respect to the bilateral contract.

The CHAIRMAN. Mr. Ireland, is it your thought that regulation ought to extend to those private contracts as well?

Mr. IRELAND. My thought is that we ought to treat natural gas more as an agricultural commodity, and agricultural commodities were excluded from many of the exemptions created in the Commodity Exchange Act and the Commodity Futures Modernization Act. To a certain extent, yes, we would restore some of the CFTC provisions applicable to the natural gas contract that do not apply now to over-the-counter transactions.

The CHAIRMAN. Before I forget, Mr. Pickel, you mentioned weather derivatives. Again, explain that to me if you will. Give me your definition again of a weather derivative and what we are talking about here.

Mr. PICKEL. It is a transaction typically entered into again on a bilateral basis using ISDA documentation, where a party may look to hedge his exposure that he might have as a result of weather activity, for instance, rainfall is typical, heating degree days, there are often contracts done on that. This is a growing, this is a newer product, but it allows, for instance, an ice cream manufacturer who thinks it is going to be—whose profits depend on it being a very hot summer, buying some protection in the event that the summer ends up being cooler than expected. This allows them through a bilateral contract to obtain some financial protection against the exposure that it might have to a cooler than normal summer.

The CHAIRMAN. Again, that would be an exempt transaction.

Mr. PICKEL. Again, done pursuant to the requirements of typically Section 2(g) of the CFMA. It is between parties that satisfy the requirements for eligible contract participants, and if it is individually negotiated as described in that particular clause, then yes, and I mean weather derivatives in particular are very much tai-

lored to the specific needs of the parties, so virtually all of those would satisfy the individual negotiation requirement there.

The CHAIRMAN. Mr. Sprecher, one issue that keeps arising is the situation involving Enron and the collapse of that company and the obvious financial effect on not just employees but investors. How is ICE different from EnronOnline and what protections are in place in your opinion that really will not allow another situation involving Enron in the industry to occur?

Mr. SPRECHER. First of all, probably the main difference between ICE and Enron is that Enron was a party to every buy and sell transaction on its EnronOnline, whereas we simply are operating a neutral marketplace. We are more like an eBay, running the eBay site where buyers and sellers come together, and we are not a party to the transactions.

I am sure of most interest to you in your unique role is that my understanding is that Enron received an exemption from oversight by the CFTC, and thanks to the foresight I guess of the committee in putting in the CFMA, companies like mine are actually in this unique category called ECMs where the CFTC does have oversight on my company and where we are tasked with anti-fraud and anti-manipulation responsibilities and accountable to the CFTC.

The CHAIRMAN. Does the CFTC ever come to you and say: We are doing some oversight on natural gas; we want to see some of your contracts?

Mr. SPRECHER. Yes, actually quite often. It is obvious that there was a fair amount of nonsense that went on in the energy markets early in this decade, and in trying to build an enforcement record and hold people accountable for their actions we have become a data repository for transactions that were done, and we often provide that information to the CFTC so that they can recompile trading. One of the luxuries of electronic trading is that it is saved in a data base and the CFTC has tasked us with the responsibility to keep those records intact and to be able to provide them to them. I would also mention to you that we have a similar relationship with the Federal Energy Regulatory Committee and work closely with them in the same vein.

The CHAIRMAN. Is there any pattern that has developed that would indicate that when certain things happen that that triggers CFTC coming to you, for example, a spike or increase in oil prices, or is there a pattern that dictates when they are going to come ask you for those contracts, or they do it just at random?

Mr. SPRECHER. It is a bit of actually a two-way street. A unique spike price is very often an example of when they would come to us, also a specific investigation that may be underway against either an unexplainable market activity or an individual company or a trader. Similarly, we have adopted with the CFTC a mechanism where if we ourselves see something in the market that we cannot explain, we report it to the CFTC so that they are aware of it, and between us work out some kind of data coordination.

The CHAIRMAN. Senator Salazar.

STATEMENT OF HON. KEN SALAZAR, A U.S. SENATOR FROM COLORADO

Senator SALAZAR. Thank you very much, Chairman Chambliss, and thank you members of the committee for spending some time with us here this morning.

My own view is that CFMA and the CFTC have been working well, but this is an opportunity, as you go through the needle of reauthorization, to figure out how we might be able to improve the law.

My distinguished colleagues Senator Leahy and Senator Feinstein have talked about the need for additional oversight of over-the-counter energy markets and many of them have talked to me about the need to move forward, and in that direction, Senator Feinstein has legislation that would modernize the act from her point of view and would give additional authority to prevent fraud and manipulation in the energy markets.

I was wondering whether you might share with me your perspectives on Senator Feinstein's legislation and whether or not that is a direction that we should be encouraged to head in as we review the reauthorization of CFMA?

Mr. PICKEL. Perhaps I will start on that, and obviously we have been active in the past 5 years as we have seen Senator Feinstein's proposal come up for consideration on the floor of the Senate and reacting to that.

As we have all said, the CFMA was a great advance forward. One of the ways it was was recognizing that there really are several different ways in which products are transacted and entered into so that you have a provision that is very much consistent with the longstanding policy of Congress and the CFTC, that the types of bilateral contracts that people enter into privately negotiate, tailor the terms specifically to their needs, and also typically entered into using an ISDA contract, are the types of private activity that are not subject to and should not be subject to regulation by the CFTC.

Mr. Ireland mentioned the agricultural commodities which were very consciously recognized as being something separate. There are a number of provisions in the CFMA that recognize that energy may have some different features, and depending on the type of activity and the level of interaction between parties and their effect on the marketplace, there are provisions in there that put in a different layer of regulation, if you will, including anti-fraud and anti-manipulation authority, so those protections are in there. In fact, the CFTC since the CFMA was enacted has had a vigorous enforcement program in light of the California energy situation in light of some of the effects on the energy marketplace, and they should be applauded for that activity, and they have confirmed that they feel, and they have repeated this several times over the last several years, that they have sufficient authority to take action against fraud that happened in those marketplaces, and I am sure that they will continue to do that and protect consumers in the energy area.

Mr. SPRECHER. I guess I would echo Mr. Pickel's thoughts in that my company is of the opinion that the CFMA and the statutory oversight of the CFTC has the provisions that they need to run ef-

fective markets. In our dialog with the Commission they too have said to us that they believe they have all the tools that they need.

I understand the frustration in the West and am sympathetic to it. We as a marketplace want there to be fair and orderly markets. My company charges a commission on every trade, so the more trades that are done, the more money we make, and the only way you can bring more participants into a market is if they feel that it is fair and orderly.

With respect to the specific Feinstein legislation, we think that it is a bit redundant from what is already available to the CFTC.

Senator SALAZAR. Mr. Ireland.

Mr. IRELAND. Senator Salazar, our particular concern is the natural gas contract, and more particularly, volatility in the natural gas contract. As I understand Senator Feinstein's legislation it is substantially broader than that. Like my colleagues on the panel we generally think that the CFMA has worked well and that the Commodity Exchange Act has worked well as amended by the CFMA, and we have a much narrower issue than is addressed by the Feinstein bill.

We also think that there are particular characteristics in the gas contract that are different than other energy contracts.

Senator SALAZAR. I am interested also to find out a little bit more about these weather derivatives. My wife is the proud owner and operator of a Dairy Queen and——

[Laughter.]

Senator SALAZAR. [continuing] is very acutely aware of what happens when you have a cold day and you are trying to sell ice cream. I am wondering if you could just tell us a little bit more about how weather derivatives do actually work and is it an emerging part of what is happening with commodity trading? It is a concept that I had not heard about until this morning.

Mr. PICKEL. Perhaps Mr. Sprecher can indicate whether he is developing a contract on ICE for weather derivatives. I really cited that example in my testimony as indication of innovation. New products, new ways of looking at risk, developing new tools to help companies manage the risks that they have. The traditional OTC derivative had been developed in the interest rate world, the FX world. Once that was developed people said, well are there not other types of risks we can apply this same technology, if you will, to manage risk?

Weather is one of the next steps. I do not know that people would say that it is going to grow into the size of business that that interest rate and currency or the credit derivative business is, but nevertheless, it is an indication that by having the right regulatory framework you encourage innovation, people are developing new tools.

As far as the specifics of the trade, it is really very much dependent upon where somebody works or has their Dairy Queen or has their factory, where they have their market, what the particular historical weather trends are, because it is very much—the pricing of it, the level at which you are willing to buy or sell protection is very much dependent upon what the historical experience is, and fortunately here in the United States we have a very deep and rich history of collecting rainfall data, temperature data, so it provides

a very conducive environment for developing that. Other countries do not have that same rich history in terms of collecting that information, so it is a product that has potential, has application, but it is really cited by me more as an example of innovation than in terms of the next big thing.

Senator SALAZAR. I have to go to a meeting with the Secretary of Interior but I wanted to thank the panel for participating here with us this morning, and I applaud and appreciate the leadership of Chairman Chambliss on this important issue and look forward to the reauthorization of CFMA.

Thank you very much.

The CHAIRMAN. Thank you very much, Senator Salazar.

Mr. Sprecher, the acronym of ICE may be an appropriate acronym to initiate these weather contracts.

[Laughter.]

The CHAIRMAN. I want to be a little bit informal because I have been informed that Senator Harkin is now not going to be able to make it, and I do not want to have all this expertise here and not take full advantage of it. Just before we close, if any of the three of you have any comments that you feel need to be made relative to any further explanation of anything you have said or anything we have not asked about, I want to give you an opportunity for that. Does anybody want to make any additional comments?

Mr. PICKEL. Mr. Chairman, I might just reemphasize something that I mentioned in my testimony. I am sure you are well aware of these provisions, principally in the energy bill in the past Congress that were amending provisions of the Commodity Exchange Act, and it is important for you and for your committee to work with the Energy Committee to let them know that you have a process this year in reauthorization, you are going to be looking at various aspects of the CEA and that it is really appropriate for those issues to be considered through your committee and not through other processes. I would just reemphasize that.

The CHAIRMAN. Thank you. That will be done. When we went through the reauthorization back in 2000 I was on the subcommittee that Congressman Tom Ewing chaired over on the House side, and of course, Tom led the way on our side on that, and basically it was two of us that worked on that side. The one thing that I walked away from that process with was an understanding that this was a highly complex area of the financial community that unsophisticated people needed to stay away from. I am not just sure how much Government involvement ought to be relative to the ability of individuals to enter into contracts.

By the same token I am sensitive to what you said, Mr. Ireland, relative to outside transactions having an influence on market transactions. I do want to make sure that as we go through this process we thoroughly vet that and make sure that we give it every due consideration as to whether or not there should be some regulation.

In that vein, let me just close with you by saying, as I am going to tell the other panel, as I told the folks on Tuesday, we are not asking for any additional comments. We have your statements. We know where your positions are. If you want to provide any comments, suggestions, recommendations to us in writing in addition

to what you have done already as a result of this hearing and the hearing on Tuesday, please feel free to do so.

We do not have a timeline set. Senator Harkin and I have talked about the fact that we are going to complete this hearing, analyze the information that we have received, and then we will move ahead. I just want to make sure that we let everybody who has a stake in this complex issue to feel like they have had full opportunity to provide us information.

Again, thank you all very much for being here. We appreciate your testimony and participation.

We will move to the next panel which will be Mr. Daniel J. Roth, President of the National Futures Association of Chicago; Mr. John G. Gaine, President, Managed Funds Association here in Washington, DC, and Micah S. Green, President of the Bond Market Association here in Washington, DC.

Gentlemen, thank you very much for being here today. We appreciate your participation in this process as we move forward with reauthorization of CFTC, and we will again go down the line, starting with you, Mr. Roth. Thank you, and we look forward to your testimony.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILLINOIS

Mr. ROTH. Thank you, Mr. Chairman.

National Futures Association is the industry-wide self-regulatory body for the futures industry, and I know that the process of self-regulation has come under a fair amount of criticism over the last couple of years, and the problems that have been encountered over in the securities industry have been very well publicized.

What has not been very well publicized is the success that self-regulation has had in the futures industry, and what I would point out to you is that since 1982, which is when NFA began operation, since the date that NFA began operation——

The CHAIRMAN. What was that, 1982?

Mr. ROTH. 1982. Since that time volume on U.S. futures exchanges has increased by over 1,200 percent. During that same period of time customer complaints have actually dropped by 74 percent, and that is a fairly significant and dramatic achievement, and it is an achievement that was not an accident. It was the result of a lot of hard work. It was the result of a very close working partnership between the CFTC and NFA to close down the boiler rooms and the bucket shops that generated so many of those complaints.

Today though I am concerned that all the progress that we made in shutting down those types of firms, all that progress may be in jeopardy, and it may be in jeopardy because the CFMA, for all of its success, failed to achieve one of its customer protection objectives. In the CFMA Congress tried to clarify once and for all the CFTC's authority to protect retail customers that were investing in foreign currency futures. As we sit here today, the Commission's authority to protect retain customers may be more uncertain now than it was then, and the main problem is the *Zelener* decision from the 7th Circuit that you have heard about and that we talked

about at some length in the last hearing. That decision, in my view, really did three things.

No. 1, it made it a lot harder for the Commission to prove that these leveraged contracts marketed to retail customers to speculate in commodity prices made it much harder to prove that those contracts are in fact futures. No. 2, the decision made it much easier for the unscrupulous, for the fraud guys to set up their operations in such a way that they can place themselves beyond the reach of the CFTC. No. 3, by doing those two things, that decision, in my view, created an honest to God real live customer protection issue.

To make matters worse, the committee should be aware that this is not a foreign currency problem, per se. There was nothing in that *Zelener* decision that limited its rationale to that particular product, to foreign currency products. The scammers that are setting up boiler rooms to sell foreign currency products under the *Zelener* decision could just as easily sell heating oil products, unleaded gas, natural gas, ag products, metal products, anything.

In the view of National Futures Association, this decision has created a real customer protection issue, and we feel that it is an issue that Congress has really got to tackle head on.

In all the discussions I have heard four different reasons why Congress should not reopen the Act, why Congress should not address this issue, and frankly, I do not find any of them particularly persuasive.

No. 1. I have heard some argue that there is no need to clarify the CFTC's authority to protect retail customers because the State regulators have all the authority necessary to go after these firms. I have spent over 20 years working with State regulators, and I can tell you firsthand that I know that they are dedicated and they are committed and they are intelligent and they are overwhelmed. If anybody thinks that the State regulators have both the resources and the expertise to protect retail customers from these futures look-alike scams, well, they are just dreaming.

No. 2. I have heard people say that there is no need for Congress to act here because the CFTC may be able to litigate its way out of the *Zelener* problem, that the CFTC can just bring different types of cases with different types of evidence, and deal with the problem that way.

Mr. Chairman, I have explained in my written testimony why that is nowhere near as easy as it sounds, and that really to try to rely on litigating our way out of the *Zelener* problem places an awful lot of chips on a bet that is no sure thing.

No. 3. I have heard that it is just premature. You know, the *Zelener* decision was handed down by the 7th Circuit last August. The CFMA itself is relatively new and it is just premature to be doing anything at this point and we should wait and let events unfurl. Well, realistically, if we talk about waiting, or waiting till the next reauthorization, and we all know that an awful lot of people can get hurt in 5 years, and I just do not think that that is an acceptable approach.

The final thing that I have heard, Mr. Chairman, is that if Congress does act in this area, whatever we do should be limited to deal with just Forex products and not go beyond foreign currency products. Well, as I explained earlier, I do not think the problem

is limited to foreign currency products, and I do not think the solution can be limited to foreign currency products either.

I recognize very well that there are very legitimate concerns about a legislative fix to this problem. I know that all of us are fearful of unintended consequences, and my goal here is to restore the CFTC's jurisdiction, not to expand the CFTC's jurisdiction, and my goal here is to protect retail customers and not to in any way interfere with institutional business. I know there is always a threat of unintended consequences, but all that means is that it is a hard problem to solve, and just because it is hard does not mean it cannot be done.

We feel that legislative action here is mandatory. We have to come up with the right solution, and NFA is very much dedicated to working with this committee, to working with the industry, to working with the Commission, and to work with anybody else that can help us find a solution that is practical, that is politically acceptable, and that actually achieves the goal of customer protection.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Roth can be found in the appendix on page 218.]

The CHAIRMAN. Thank you.

Mr. Gaine.

STATEMENT OF JOHN G. GAINE, PRESIDENT, MANAGED FUNDS ASSOCIATION, WASHINGTON, DC

Mr. GAINE. Chairman Chambliss and members of the committee, my name is Jack Gaine. I am President of Managed Funds Association, and I thank you for the opportunity to share our views with you today about the CFTC's reauthorization.

I will be very brief in my oral comments but would ask that my written statement be included in the record.

We commend the committee for this timely hearing and we commend the CFTC for their steady, sensible hand in implementing the CFMA over the last 4 years. We are not advocating any statutory change at this time, but I will put a footnote on that and say that with regard to Mr. Roth's concern about a gap in the antifraud provisions, we certainly are, as NFA is willing to, willing to work with him, the committee, et cetera, to close any real gaps that exist in order to provide full public protection against fraudulent activities.

MFA is the primary trade association representing professionals who specialize in the alternative investment industry which consists of funds of funds, futures funds and hedge funds. We have over 850 members including representatives of 35 of the 50 largest hedge fund groups in the world. Our members, many of whom represent firms that are registered with the CFTC as commodity trading advisers and commodity pool operators, manage a substantial portion of the over one trillion dollars invested in alternative investment products globally. We are major users of the futures markets and many of us are regulated by the National Futures Association as well.

Since the last reauthorization we have worked extensively with the CFTC on a number of important rule-making projects as well

as private sector initiatives which I have detailed in my written statement.

We are different from most of the witnesses who will appear before you because we are the user of a lot of the facilities and the services that are provided by the exchanges and other witnesses. Increased interest in and use of alternative investments is a direct result of the growing demand from institutional and other sophisticated investors, for investment vehicles that deliver true diversification and help them meet their future funding obligations and other investment objectives.

Our members' funds perform a number of important roles in the global marketplace, including contributing to a decrease in overall market volatility, acting as shock absorbers and liquidity providers by standing ready to take positions in volatile markets when other investors choose to remain on the sidelines. Moreover, our funds utilize state-of-the-art trading and risk management techniques that foster financial innovation and risk sophistication among market participants.

Let me turn briefly to just two or three specific issues. Hedge funds' effect on the energy markets, and I will put a footnote to this as well, that at Tuesday's hearing, President Newsome released a study that the NYMEX had done on the role of hedge funds in natural gas and crude oil futures. I have read the report. It is very comprehensive and it has a lot of data and makes a very strong case that there is no adverse effect on the energy markets by virtue of hedge fund activities.

Energy markets enjoy all of the described benefits provided by the alternative investment industry. Recently, there has been increased discussion about hedge funds' impact on energy. Some participants have argued that price swings and volatility are a result of the impact of speculative futures trading by hedge funds.

Recently both the CFTC, and the Federal Energy Regulatory Commission concluded that hedge funds really were not the cause of the volatility. We also believe that the CFTC is doing an excellent job in overseeing the energy trading market. They have assessed penalties of approximately $300 million in recent years. The industry, including MFA members who trade in these markets, benefit from appropriate regulatory actions since these actions promote fair and efficient pricing in the marketplace.

We are comfortable that the CFTC, the FERC and the New York Mercantile Exchange each have correctly recognized that hedge funds are not dominating energy trading, and that the current system in place is adequate to provide public protection.

We would ask this committee, in its oversight function, to urge the SEC and CFTC to work cooperatively to avoid duplicative regulation. I have gone into more detail in my written testimony. We would ask also that the committee, in its oversight function, urge the CFTC to act on the petitions of the various exchanges—Chicago, Minneapolis and Kansas City—to liberalize or relax the speculative position limits on a number of agricultural contracts.

In conclusion we think the CFMA was a masterful piece of work. We think the implementation has been excellent. We stand ready to assist the committee, answer any questions and work with Mr.

Roth, because he seemed to include the world in the people he is willing to work with, in solving any of his problems.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Gaine can be found in the appendix on page 224.]

The CHAIRMAN. Thank you very much, Mr. Gaine.

Mr. Green.

STATEMENT OF MICAH S. GREEN, PRESIDENT, THE BOND MARKET ASSOCIATION, WASHINGTON, DC

Mr. GREEN. Good morning, Mr. Chairman. Thank you very much for allowing the Bond Market Association to participate in this hearing on the reauthorization of the CEA and in particular the changes made in 2000 under the CFMA, a law which, by the way, we believe was an outstanding achievement of the Congress.

Through our offices in New York, Washington, and London, the Association represents the $44 trillion global bond markets. Our members include all major dealers in Federal agency bonds, as well as the securitization market, corporate and municipal securities, in addition to all of the primary dealers of U.S. Treasury securities as recognized by the Federal Reserve Bank of New York. Our members are also active in the markets for over-the-counter financial products and contracts involving forward payments or deliveries relating to a variety of fixed income securities, interest rates and credit products.

The Bond Market Association participated actively in the debate that led to the enactment of the CFMA. At that time we advocated changes to the CEA that were viewed as critical to vibrant markets in OTC securities, derivatives and foreign exchange. The CFMA has proved to be extremely successful in that regard because it clarified the exclusion from the CEA and the jurisdiction of the CFTC of OTC derivatives, swaps and foreign exchange transactions. The much-needed legal certainty the Treasury amendment in the CEA continues to bring these important sectors of the capital markets, enables markets for U.S. Treasury securities in particular, which allows the Government to borrow at a lower cost and save U.S. taxpayers real money.

I want to congratulate this committee and your counterparts in the House, as well as past and current leadership and members of the CFTC for your foresight in enacting the CFMA nearly 5 years ago. You clearly anticipated the expansion of the markets around the globe and the need to facilitate liquid and efficient markets wherever they may exist, and to particularly ensure that U.S. markets are not at a disadvantage. You clearly sensed that prescriptive rules and regulations in an economy that require nimbleness and flexibility would make it more difficult for markets to adjust to changing conditions, and that sound principles-based rules ensured that markets function smoothly even in times of stress.

Finally, you clearly foresaw the development of sophisticated risk management techniques that permit institutional market participants to manage risk in an increasingly precise manner. Market participants can retain the risk they wish to retain, and for a fee transfer those risks they do not wish to retain to other market participants. These improvements in risk management facilitated by

the OTC derivatives market have helped the U.S. and global economies weather recessions and interest rate volatility. In other words, the leadership you provided nearly 5 years ago when you were in the House and now in the Senate, was really quite extraordinary and has provided tangible benefits to the economy.

The Bond Market Association set out three fundamental policy goals during the last reauthorization process. We called for maintaining the OTC markets as a viable alternative to traditional organized exchanges, preserving the enforceability of contracts freely negotiated between market participants, and avoiding duplicative regulation.

I am happy to report for the benefit of the broader national and global economies the CFMA did in fact meet those goals. Clarifying the exclusions for commodities and swaps from the CFTC's jurisdiction and assuring contract enforceability as the CFMA does, have brought the OTC derivatives market the legal certainty it needed to thrive.

In closing, Mr. Chairman, I would like to reiterate our support for the CFMA. The law strikes a delicate balance between regulating a rapidly changing market and encouraging innovation and diversity. Prior to the CFMA, the OTC derivatives market was restrained by legal uncertainty. Again, thanks to the foresight of the Congress and particularly this committee, this market is now thriving and helping to save taxpayers money by lowering the cost of borrowing for the Federal Government. Improved risk management and lower capital costs also help to stimulate the broader economy.

In the context of the reauthorization process, the Association strongly urges this committee and Congress not to alter any of the fundamental elements of the CFMA that encourage and orderly and innovative OTC derivatives market.

Thank you very much for the opportunity to testify.

[The prepared statement of Mr. Green can be found in the appendix on page 231.]

The CHAIRMAN. Thank you very much, Mr. Green. In your written testimony you mention a 2002 observation by Federal Reserve Board Chairman Alan Greenspan, that complex financial instruments developed to manage risk have made the global economy, and a I quote, "a far more flexible, efficient and resilient financial system that existed just a quarter-century ago."

Would you elaborate on that a little bit, and what is the role of the over-the-counter derivatives such as swaps in this development?

Mr. GREEN. If you think about risks in the marketplace you have interest rate risks and the movement of the markets, and you have credit risk, if you have credit exposure. As Mr. Pickel described earlier, you can now look at other risks that are out there, catastrophic events. You can look at weather-related issues, virtually—any risk that right now is manageable that many years ago was not manageable—and in an economy where you cannot necessarily predict what is going to happen as it relates to interest rates, as it relates to credit quality, as it relates to weather and other potentially uncontrollable events. The ability to manage that risk allows you to absorb changes in a much more measured and much more organized way. In fact, there was a time about a summer and a

half ago, interest rates spiked up tremendously at a time when interest rates were at record lows. In previous years when that happened in 1998 or 1994 you would have seen a particular catastrophic event in the marketplace, and I am not saying for a second that there will not be future catastrophic events in marketplaces, but it is instructive to see that that happened post-CFMA, and you saw the marketplace absorb it.

Now, obviously, when there are losses in the market, the losses find themselves somewhere, but they are less concentrated now because people have been able to use the financial products, again, that the CFMA has allowed for privately negotiated and very specialized and precise contracts to allow for that very knowledgeable management of that risk and absorb the changes in the economy.

The CHAIRMAN. Did that flexibility exist prior to the Modernization Act in 2002?

Mr. GREEN. Not to the degree it does now. There was uncertainty, and every bit of uncertainty, no matter how minute it is, carries with it a cost and a burden to the free flow of the economy. There is no question that the CFMA has contributed greatly to dealing with that legal uncertainty.

The CHAIRMAN. Who is the beneficiary of that flexibility? Is it more the market or the customer?

Mr. GREEN. Everyone. The fact is that when the marketplace can absorb sudden changes in interest rates or credit quality or virtually any other thing, everyone—and frankly not just in the United States but around the globe—benefits and it allows for the absorption factor. It is like driving a car without shock absorbers. You need those shock absorbers, and that is all about risk management, and certainly the parties involved in the transactions benefit from that, but the customers of those people and the beneficiaries of the products and the economy generally benefits.

The CHAIRMAN. What if any effect would the Feinstein legislation, in your opinion, have on that flexibility?

Mr. GREEN. Well, I share the views that were expressed by the prior panel. We believe that the CFTC has the authority, and they have exercised that authority, to their credit. What we worry about is imprecision and building of more uncertainty, and that is why we join in calling that this committee particularly, with its expertise in the CEA and the CFMA, needs to make sure that it carries out its will in this process as opposed to writing this sort of legislation on the floor, because it is a very delicate piece of legislation. You remember from the House how really masterfully, you all put it together in a way that made sense for the market and the market participants, and if any changes were to lead to uncertainty, you would basically be turning back the hands of time. We are worried that the Feinstein amendment, No. 1, is not needed; No. 2 was overly broad, leading to more uncertainty. We would join certainly with Mr. Pickel, and the Bond Market Association has worked very closely with ISDA on that issue in opposing such an amendment.

The CHAIRMAN. Before I leave that particular issue, let me ask Mr. Gaine and Mr. Roth for your reaction to the Feinstein proposal.

Mr. GAINE. I really would only echo Mr. Green and the earlier panelists and my own testimony here, that the existing statutory

and regulatory framework that is in place has been shown to be adequate to address the issues.

I do feel Mr. Ireland's pain. We all would like lower energy prices, but the volatile supply and demand domestically and internationally, factors that are at play now, unfortunately do not give us that luxury. Having markets that can adapt nimbly and quickly, are very important, and the cause of any volatility, are the fundamental supply and demand factors.

The CHAIRMAN. Mr. Roth.

Mr. ROTH. Mr. Chairman, I would just point out that from a regulatory point of view, every time you run into an issue what you are really trying to do is the most efficient to deal with any regulatory issue is to provide the least degree of regulation that you need to do to accomplish the results and generally let the markets work out the rest.

We always, in any issue that we encounter, try to figure out what is the least burdensome method to achieve the desired result. That is always what you are striving to do because that is what avoids the unintended consequences that I was referring to earlier. Without getting specific as to the Feinstein amendment, all the comments from the other panelists are really attuned to that same basic philosophy to make sure that the regulations that you do impose are sufficient to achieve the desired objective without being too burdensome and having those unintended consequences. Everything that Mr. Pickel and Mr. Green and Mr. Gaine have said, are certainly things that philosophically NFA would agree with.

The CHAIRMAN. Mr. Roth, you talked about the amount of increase in contracts since 1982, and the correlating decrease in complaints. I notice in your testimony, I believe, you had, what, 93 complaints in the last year, which does seem like a fairly minimal number. What kind of increase have you seen since the CFMA relative to the increase in contracts and decrease in complaints?

Mr. ROTH. Let me just put in context the statistic that you cited from my testimony. One of the points we make in our written testimony was that Congress may want to reconsider whether it should continue to require the CFTC to operate a reparations program, which is a dispute resolution program for customers, and it is a program that has been in place for a very long time, since back in the 1970's. What we pointed out was that back when the program was instituted the world was a much different place. For one thing the boiler rooms were really a problem of much greater scope than they are right now, generating a lot more customer complaints than we have now. No. 2, NFA had not even begun operations yet, and our arbitration program that we offer customers had not been in place yet.

What we point out in our testimony was that back in 1982 when NFA began operations the CFTC used to get a thousand complaints a year in the reparations program, and last year they had 93.

Our point is that we think maybe that is a program that was valuable at its time but maybe has outlived its usefulness and maybe the Commission could redeploy its resources elsewhere, and maybe it is time to get rid of the reparations program. That is the specific point about this statistic.

With respect to the CFMA and its impact on customer complaints, I can tell you that for the most part we have been able to keep the level of customer complaints at near record level lows. What is of concern to me is that with respect to, again, retail Forex problems, completely apart from the *Zelener* decision. You know, we have members that are Forex dealer members of NFA that we regulate and we have about 27 members that are active in that area right now, and though few in number, those retail Forex accounted for about over 20 percent of the customer complaints we received in arbitration last year at NFA. That even apart from *Zelener* there have been regulatory problems with respect to retail Forex. It is a disproportionate share of our customer complaint docket and it is something that we are going to continue to work on and struggle with.

Where we have the authority to act, at least we can act. The *Zelener* problem creates issues where neither the CFTC nor NFA would really have the authority to regulate that activity.

The CHAIRMAN. I want to make sure you have answered my next follow-on thought process, and that is I hear what you are saying when you say that the *Zelener* decision has brought on some problems, some of those unintended consequences almost that we did not anticipate with the legislation. I noted your suggestions and comments relative to the reasons why, and your response is too there should be no changes in the Act. By the same token what I am hearing from you is that you like the idea of self-regulation, that you do not want any more Government involvement than you have to have. The same token you want to make sure that you have the ability I guess to put some teeth into the self-regulatory process that maybe you do not have now. By the same token you are saying that you have had a tremendous increase in the volume of contracts and a collateral declining decrease in the number of complaints.

I am just wondering why we really ought to think about making changes when that scenario is in place.

Mr. ROTH. Mr. Chairman, the reason we have to make a change is that the reason that we have been able to achieve a dramatic drop in customer complaints is that there was a regulatory presence and a strong regulatory presence where these types of products were being marketed to retain customers. That is how we got to where we are. The problem with the *Zelener* decision is that it creates the exact opposite environment, where that marketing activity can go on with retail customers in a completely unregulated environment. The format, the way we got to where we are is by having a regulatory presence with respect to the protection of retail customers. The *Zelener* decision threatens to undo that and that is why I am concerned about it.

The CHAIRMAN. Mr. Gaine, you heard the previous panel talk a lot about the energy market and in particular the natural gas market. Can you explain how hedge funds increase liquidity with respect to the energy market and how this benefits the market?

Mr. GAINE. Yes. This was probably discussed in some detail. First, I am just a lawyer, not an economist. Maybe that is a plus. It is discussed in some detail in the NYMEX study that I referenced that was released several days ago. In their analysis they

did a study of trading activity over certain periods of time, and actually found that hedge fund activity decreased the volatility, and they did it by using mathematics and looking at the trading records over a considerable period of time, both in natural gas and crude oil futures. The increase in liquidity would as a general proposition serve to be neutral or favorable toward reducing volatility, and we certainly do provide that to these markets.

As I said, hedge funds have to come in to the market and have to get out of the market. They are not going to stand for delivery. They do not take a position in crude oil and then put it in the tanker and put it offshore. They are going to liquidate that, so they are going to be both a buyer and seller in most instances. As I say, they are expanding the pool, the liquidity pool. That coupled with the findings of the study that I referred to make a fairly firm case that they are a plus to the pricing discovery and other functions of the futures markets.

The CHAIRMAN. Gentlemen, again, we have had a vote that was just called, so we are going to have to conclude anyway. We do have a few minutes, and I want to give you the same opportunity that I gave the last panel. We are in a little more of an informal situation here. If anybody has any additional comments you want to make relative to anything you said or any other issue that has been brought up, I want to make sure that we get all of the input from you we can. I will give each of the three of you that opportunity if you would like to.

Mr. GAINE. Mr. Chairman, if I might just say I would like to associate particularly with Mr. Green's comments about the pocket of expertise that resides in 328 Russell with respect to many of these issues, and it is a problem on this side, but even a greater problem in the other body. It is very important that any crafting or any considerations of changes to these highly complex issues be really managed by those who are in the know, which is this committee and its members and its staff.

The CHAIRMAN. I appreciate that compliment, particularly as a recovering lawyer myself, Mr. Gaine.

[Laughter.]

The CHAIRMAN. As we move through this, it is a very complicated issue, as all of you have explained and as we know. We would appreciate a continuing dialog with you because that is the way the best legislation is ultimately produced.

While we have your written testimony, while we have your comments today, if there is any other written suggestions or comments, not just on what may have been said over the last couple of days, but there are going to be other developments. We do not know where the *Zelener* decision is going, Mr. Roth. I agree with you that may present a whole new factual set of circumstances to us that may evolve even further between now and the time legislation is crafted.

We would appreciate your input and appreciate your comments and your continuing dialog with staff and with our offices also.

Thank you very much for being here. We are going to leave the record open for 5 days. I feel certain that Mr. Harkin probably will have some questions to ask one or both panels. We would ask that you get those responses to us as soon as possible.

There are many groups that have an interest in the reauthorization process, and without objection written testimony submitted today may be included in the record.

Thank you very much for being here and for your participation. This hearing is concluded.

APPENDIX

March 10, 2005

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

TESTIMONY OF JEFFREY C. SPRECHER
CHAIRMAN AND CEO
INTERCONTINENTALEXCHANGE, INC.

MARCH 10, 2005

Chairman Chambliss, Ranking Member Harkin, members of the Committee, I am pleased to testify today. My name is Jeffrey C. Sprecher and I am the founder, Chief Executive Officer and Chairman of IntercontinentalExchange, Inc. (ICE). ICE operates the leading global electronic over-the-counter, or OTC, marketplace for trading energy commodities and derivative contracts based on energy commodities. ICE's leading Internet-based electronic platform brings together buyers and sellers of energy commodities and OTC derivative energy contracts. ICE also operates an energy futures exchange through its wholly-owned U.K. subsidiary, the International Petroleum Exchange, or the IPE.

I would like to thank the Committee for its effective and far-sighted work in developing and adopting the Commodity Futures Modernization Act of 2000 (CFMA). Among its many achievements, the CFMA provided for a new category of trading facility, the exempt commercial market, or ECM. This Committee recognized that electronic marketplaces whose participants are limited to eligible commercial entities trading on a principal-to-principal basis do not require the same level of federal oversight as futures exchanges that are accessible by the general public. ICE operates as an ECM today because of the good work of this Committee in adopting the CFMA.

I. ICE OVERVIEW

Headquartered in Atlanta, Georgia, ICE was formed in 2000 pursuant to a no-action letter from the Commodity Futures Trading Commission (CFTC), the terms of which were later that year substantially codified in the CFMA. ICE operates a "many-to-many" electronic platform that allows buyers and sellers of derivative energy contracts and physical commodities to view and act upon each other's bids and offers. ICE's electronic platform automatically matches buyers and sellers posting the best bids and offers according to a neutral "first-in, first out" algorithm, thereby ensuring a level playing field for both the largest and smallest of its market participants. ICE itself is not a party to any of the transactions on its platform and does not participate as a principal in the markets for energy commodities trading in any forum.

ICE's electronic marketplace is globally accessible, promotes price transparency and offers participants the opportunity to trade a variety of energy products. Its key products include energy derivative contracts for crude oil, natural gas and power. Among other things, its products provide market participants with a means for managing risks associated with changes in the prices of energy commodities, ensuring physical delivery of energy commodities, and the ability to obtain exposure to energy commodities as an asset class. The majority of ICE's energy contracts are financially settled, meaning that payment is made through cash payments based on the value of the underlying commodity rather than by actual delivery of the commodity itself.

ICE's electronic platform is designed to enhance the speed and quality of trade execution. In addition, its platform offers a comprehensive suite of trading-related services,

including OTC electronic trade confirmation and access to clearing services. ICE also offers a variety of market data and information services.

ICE operates its OTC business through its globally accessible electronic platform, and offers trading in a wide variety of OTC energy contracts. ICE's customers, representing many of the world's largest energy companies and leading financial institutions, as well as proprietary trading firms, natural gas distribution companies and utilities, rely on its platform for price discovery, hedging and risk management. As of the end of 2004, ICE had over 5,000 screens at over 860 participant trading firms, and on a typical trading day over 3,600 individual screen users are connected to its platform for trading. OTC contracts available for trading on its electronic platform include forwards, options, swaps, differentials and spreads. ICE introduces trading in additional, complimentary products on its electronic platform on a regular basis, leveraging the scalable and flexible nature of its platform. We believe that ICE has enhanced the ability of market participants to access and utilize the energy markets by creating more competition through an innovative trading mechanism and complete transparency of prices and transactions. These factors, in our view, have allowed participants to trade more efficiently and effectively, which also serves the larger public interest.

A. Trade Execution Services

Participants executing trades on the ICE platform can take advantage of a broad range of automated OTC trade execution services, including straight-through trade processing and electronic trade confirmation. Prior to the commencement of trading on ICE, virtually all OTC energy derivatives trading was conducted either directly between two counterparties, or through "voice brokers," which matched buyers and sellers through telephone conversations. These mechanisms, however, are cumbersome and inefficient and do not allow market

participants to find the opposite side of a desired transaction quickly or cheaply. Moreover, pricing in these markets was completely opaque, with no centralized location to capture bids, offers or transaction prices. ICE has transformed these markets by providing OTC market participants with the ability to view bids, offers and transactions on a completely transparent basis and to execute transactions quickly and efficiently by a click on a computer screen.

eConfirm is ICE's electronic trade confirmation system. eConfirm offers market participants an automated, reliable, and low-cost alternative to manual trade verification and confirmation. eConfirm reviews electronic trade data received from individual traders, screens and matches this data electronically, then highlights any discrepancies in a report to the traders' respective back offices. In doing so, it significantly decreases the risk of "confirmation errors" and dramatically reduces the recordkeeping burden on companies by feeding directly into the risk management and recordkeeping systems of companies. eConfirm is available for use by both ICE market participants and OTC market participants who trade through voice brokers or other means.

B. Centralized Clearing Services

ICE's most actively traded and liquid OTC markets include those with contracts that can be traded bilaterally or cleared at the customer's option. In order to provide participants with access to centralized clearing and settlement, ICE launched the industry's first cleared OTC natural gas and oil contracts in March 2002, and introduced the first cleared OTC power contracts in December 2003. In a cleared OTC transaction, our clearing services provider, LCH.Clearnet, acts as the counterparty for each clearing member that is a party to the transaction (with each clearing member in turn acting on behalf of its customer), thereby reducing the credit risk that would otherwise be presented by a traditional principal-to-principal OTC transaction.

Participants who are comfortable with the credit of their counterparty may prefer to trade on a bilateral basis. The introduction of cleared OTC contracts has provided participants with an important alternative to bilateral clearing, by reducing the amount of collateral participants are required to post on each OTC trade, as well as the resources required to enter into multiple negotiated bilateral settlement agreements to enable trading with other counterparties. In addition, the availability of clearing through LCH.Clearnet for both ICE's OTC transactions and futures trades conducted through the IPE enables participants to cross-margin certain of their futures and OTC positions, meaning that a customer's position in its futures and OTC trades can be offset against each other, thereby reducing the total amount of collateral a customer must deposit with LCH.Clearnet.

The availability of clearing services and the attendant improved capital efficiency has attracted new participants to the market for energy commodities trading. The growing number and type of participants trading on ICE's platform has increased liquidity as well as the volume of gas, power and oil contracts traded. There are 23 futures commission merchants (FCMs) clearing transactions for the approximately 1,200 participants active in ICE's cleared OTC markets. As of February 2005, open interest in ICE's cleared OTC contracts was approximately one million contracts in gas, power and oil.

C. Market Data

ICE also serves the market data needs of its participants and the broader marketplace through the 10x Group, ICE's market data subsidiary. Established in 2002 in response to growing demand for objective, transparent and verifiable energy market data, 10x generates market information and indices based solely upon auditable transaction data derived from actual OTC trades executed on ICE's electronic platform and/or confirmed through ICE's

eConfirm. Each trading day, 10x delivers proprietary energy market data directly from ICE's OTC market to the desktops of thousands of market participants. 10x publishes ICE Daily Indices for OTC natural gas and power contracts for 60 of the most active natural gas hubs and 30 of the most active power hubs in North America. 10x was recently recognized by the Federal Energy Regulatory Commission (FERC) as the only publisher of natural gas and power indices to fully comply with all of the gas and power index publishing standards identified in the FERC Policy Statement of Price Indices. 10x transmits the ICE Daily Indices via e-mail to 7,100 energy industry participants each trading day. 10x also provides an End of Day Report which is a comprehensive electronic summary of daily trading activity on ICE's electronic platform. ICE's operations generate an increasingly broad range of market data, which is distributed on a real-time and historical basis.

D. IPE

ICE's wholly-owned subsidiary, the IPE, operates as a Recognized Investment Exchange in the United Kingdom and is the second largest energy futures exchange in the world. All IPE futures and options trades are executed either on the open-outcry exchange floor or on ICE's electronic platform and, in either case, all transactions are cleared by LCH.Clearnet. On March 7, 2005, IPE announced that it will be closing the open-outcry trading floor and transitioning to conducting trading exclusively on ICE's electronic platform. IPE members and their customers include many of the world's largest energy companies and leading financial institutions. IPE offers trading in the IPE Brent Crude futures contract, a benchmark contract relied upon by many large oil producing nations to price their oil production. IPE also trades other futures contracts, including gasoil and other energy products.

II. CFTC OVERSIGHT OF ICE

Pursuant to the terms of the CFMA and regulations adopted by the CFTC to implement the CFMA, ICE operates its OTC electronic platform as an ECM. The CFMA and CFTC regulations require that all ICE participants must qualify as eligible commercial entities, as defined by the CFMA, and that each participant trade for its own account, as a principal. Eligible commercial entities include entities with at least $10 million in assets that incur risks (other than price risks) relating to a particular commodity or have a demonstrable ability to make or take delivery of that commodity, as well as entities that regularly purchase or sell commodities or related contracts and are part of a group with at least $100 million in assets or assets under management. ICE has obtained orders from the CFTC permitting floor brokers and floor traders on U.S. and non-U.S. exchanges to be treated as eligible commercial entities, subject to their meeting certain requirements.

As an ECM, ICE is required to comply with access, reporting and record-keeping requirements of the CFTC. Both the CFTC and the FERC have view only access to ICE's trading screens on a real-time basis. In addition, ICE is required to report to the CFTC transactions in products that are subject to the CFTC's jurisdiction that meet certain volume requirements, and record and report to the CFTC complaints that ICE receives of alleged fraud or manipulative activity on its markets. ICE is also required under CFTC regulations to make available to the public, at no charge, delayed prices for any products on its OTC market that perform a price discovery function. While ICE is not substantively regulated in the same manner as the designated contract markets, it is subject to oversight by the CFTC. In contrast, "voice brokers" and other OTC market participants are not subject to CFTC jurisdiction in any respect.

ICE has worked closely with the CFTC to educate the agency about its functions as an ECM. It has actively responded to CFTC requests for information and has provided input on the public record as the CFTC has developed and revised rules for ECMs. ICE has developed a good working relationship with the CFTC and looks forward to continuing that cooperative relationship.

III. REAUTHORIZATION

We look forward to working with the Committee as it considers the many issues facing the CFTC during the reauthorization process. With respect to issues affecting ECMs in particular, ICE is of the view that the CFMA and the rules adopted by the CFTC provide an effective framework for oversight of these commercial marketplaces and that there is no need to amend the Commodity Exchange Act in this area. While ICE is aware that some have recommended increased regulation of exchange and OTC energy trading, ICE does not believe that additional market restrictions would be in the public interest or would achieve the goals outlined. Price volatility in the energy markets has a number of fundamental sources, such as geopolitical events, production and consumption cycles, supply and demand imbalances, delivery locations, and seasonality. These factors will be present, and will result in periods of price volatility, regardless of the type and level of regulation that is applied to the relevant markets. Accordingly, the goal, in our view, should be to enable market participants to access the tools that will allow them to deal most effectively with price volatility. We believe that open, freely accessible and transparent markets represent the best approach for addressing price volatility, and that Congress is to be commended for recognizing this and advancing these objectives through the creation of "exempt commercial markets" under the CFMA. Restricting

trading activity through additional regulation would only adversely affect market liquidity and price transparency and would not reduce volatility.

We also believe it is important to note that, as explained above, ICE matches buyers and sellers on its electronic platform, through the use of neutral algorithm, but does not itself become a party to any transaction as principal, nor does ICE otherwise trade in the energy markets. ICE's only role is to provide an impartial and independent venue in which market participants can view bids and offers and execute transactions. In contrast to the "one-to-many" platform operated by Enron, ICE's platform is a "many-to-many" system on which participants trade with each other, not with ICE. In fact, ECMs, by definition, are necessarily "many-to-many" facilities and do not present the issues and potential problems posed by platforms such as "Enron Online."

As reflected in ICE's own experiences, market liquidity and transparency that was adversely affected in 2001-2002 as a result of the reduction in trading by many merchant energy companies has now recovered. New market participants, including financial institutions and collective investment vehicles, have added new depth to the markets and have allowed markets to more rapidly achieve price levels determined by fundamental forces of supply and demand. Complaints about high energy prices and high price volatility are not properly directed to the exchange and OTC markets that provide robust opportunities for price discovery and transparency. ICE trusts that this Committee, with its long experience with trading markets, will recognize that there is no benefit in a "shoot-the-messenger" approach to regulation.

On behalf of ICE I would again like to thank this Committee for its excellent work in enacting the CFMA. It has been a clear benefit to our company and, I submit, to producers and users of energy commodities around the world. ICE looks forward to working

with this Committee as it tackles the many issues facing the CFTC during this reauthorization process. I stand ready to answer any questions that the Committee may have about ICE or the energy trading markets.

Jeffrey C. Sprecher
is Chairman and Chief Executive Officer of IntercontinentalExchange. As CEO, he oversees Intercontinental's strategic direction, operations and financial performance. In 1997, Mr. Sprecher purchased Continental Power Exchange (CPEX), the predecessor company to IntercontinentalExchange, with the vision of building and operating a transparent electronic energy trading platform. Leveraging CPEX's technology infrastructure, he oversaw the growth of Intercontinental on a global scale. Prior to forming the company, he held a number of positions, including President, over a fourteen-year period, with Western Power Group, Inc., a developer, owner and operator of large central-station power plants. In 2001, Mr. Sprecher was named one of seven "Entrepreneurs of the Year" by Business Week magazine. He earned a Bachelor of Science degree in Chemical Engineering from the University of Wisconsin and a Masters of Business Administration from Pepperdine University.

PREPARED STATEMENT OF

ROBERT G. PICKEL

EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

(ISDA)

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY

UNITED STATES SENATE

MARCH 10, 2005

Mr. Chairman and Members of the Committee, I appreciate your invitation to testify on behalf of ISDA. ISDA has appeared before this Committee prior, and we welcome the opportunity to be with you today as you continue your important hearings with respect to legislation to reauthorize the Commodity Futures Trading Commission (the "CFTC"). The CFTC administers the Commodity Exchange Act (the "CEA"), which Congress substantially amended in the Commodity Futures Modernization Act of 2000 (CFMA).

I.

Overview

ISDA is an international organization, and its more than 600 members include the world's leading dealers in swaps and other off-exchange derivatives transactions (OTC derivatives). ISDA's membership also includes many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial, commodity market, credit, and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

The CFMA was adopted by Congress with broad bipartisan support after careful consideration over several years by four Congressional Committees and with the support of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal

Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. The CFMA sought to modernize the CEA by providing regulatory relief for the futures exchanges, ensuring legal certainty for OTC derivatives, and removing the ban on single-stock futures trading.

For the reasons I shall explain in this statement, ISDA believes that the experience under the CFMA demonstrates that there is no fundamental need to make substantive changes to the portions of the CMFA governing OTC derivatives. Moreover, from all indications, the CFMA seems to have been a broad-based success for the capital markets generally.

We understand that the Committee will want to receive a full range of views concerning the CFMA and we believe this is desirable. We do, however, urge the Committee to take a "go slow" approach to re-opening the CFMA. We also urge the Committee to assert fully its jurisdiction to review and approve any changes to the CFMA. Our experience in recent years demonstrates that the use of free-standing amendments offered to separate legislation without committee review is an undesirable method of considering changes.

II.

ISDA's Interest in the CFMA

ISDA's principal interest in the CFMA are those provisions of the legislation intended to provide legal certainty for OTC derivatives. The phrase "legal certainty" means simply that the parties to an OTC derivatives transaction must be certain that their contracts will be enforceable in accordance with their terms. As discussed more fully in Part III of this Statement, the CFMA framework for providing legal certainty is based on a long-standing consensus among Congress, the CFTC and others that OTC derivatives transactions generally are not appropriately regulated as futures contracts under the CEA.

The legal certainty provisions of the CFMA were intended by Congress both to reduce systemic risk and promote financial innovation. Our experience over the past several years indicates that both of these objectives have been achieved. A survey of corporate usage of derivatives released by ISDA in April 2003 indicated that 92 percent

of the world's largest businesses use OTC derivatives for risk management purposes and that 94 percent of the 196 U.S. companies included in the survey do so.

Moreover, the use of OTC derivatives to hedge interest rate, foreign currency and credit default risks increased substantially in the last four years, evidencing the importance of OTC derivatives as a tool to manage risk in periods of economic downturn and uncertainty.[1] As Federal Reserve Chairman Alan Greenspan noted before the Senate Banking Committee on March 2, 2002, OTC derivatives "are a major contributor to the flexibility and resiliency of our financial system." The reduction in systemic risk resulting from the use of OTC derivatives was also evident in the energy markets following the collapse of Enron in 2001. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted by Congress in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron.

The reductions in systemic risk resulting from enactment of the legal certainty provisions of the CFMA have not come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since enactment of the CFMA. For example, the significant growth in credit default swaps to manage credit risk has been greatly enhanced by the legal certainty provisions of the CFMA. Similarly, businesses ranging from ski resorts to beverage producers have begun to use weather derivatives to hedge the risk of adverse climate conditions on their businesses. Again, the legal certainty provisions of the CFMA have encouraged dealers to develop, and businesses to use, an increasing range of new kinds of OTC derivatives to manage additional types of risk. Finally, the legal certainty provisions of the CFMA removed the regulatory barriers to clearing with respect to OTC derivatives and, while collaterized transactions remain more prevalent, clearing proposals have been advanced recently and the emergence of these proposals attests to the positive effects of the CFMA on financial innovation.

For these reasons, ISDA shares the view expressed by CFTC Chairman Sharon Brown-Hruska that the CFMA "functions exceptionally well." In this connection ISDA

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[1] See Exhibit 1 (Derivatives Growth, 2000-2004, Source: ISDA).

believes that the CFTC deserves commendation for the evenhanded manner in which it has interpreted and administered the CFMA in accordance with Congressional intent, as well as for its vigorous program of enforcement following the collapse of Enron and the California energy situation. ISDA's primary members are substantial users of the regulated futures exchanges. ISDA therefore supported the provisions of the CFMA that provided regulatory relief to the exchanges and since then has welcomed the actions of the CFTC in implementing those portions of the CFMA in a manner that appears likely to promote efficiency and competition.

The legal certainty agenda remains incomplete, despite the historic advances embodied in the CFMA. Congress still needs to focus on completing action on the financial contract netting provisions contained in the pending bankruptcy reform legislation. These provisions have broad bipartisan support, have passed both the House and the Senate on multiple occasions without opposition, reflect years of work by the President's Working Group on Financial Markets and include much needed improvement to the payment risk reduction and netting provisions of the Bankruptcy Code and the bank insolvency laws.

III.

Development of the Legal Certainty Consensus

Importance of OTC Derivatives. OTC derivatives are powerful tools that enable financial institutions, businesses, governmental entities, and other end users to manage the financial, commodity, credit and other risks that are inherent in their core economic activities. In this way, businesses and other end users of OTC derivatives are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both in the United States and abroad. Almost all OTC derivatives transactions involve sophisticated counterparties, and, unlike the futures markets, there is virtually no "retail" market for these transactions.

The use of OTC derivatives is a positive force in the financial markets. As Federal Reserve Chairman Greenspan noted at a Senate Banking Committee hearing (March 7, 2002) "they (derivatives) are a major contributor to the flexibility and

resiliency of our financial system. Because remember what derivatives do. They shift risk from those who are undesirous or incapable of absorbing it to those who are." OTC derivatives are used to unbundle risks and transfer those risks to parties that are able and willing to accept them. For example, if a corporation has floating rate debt outstanding and is concerned that interest rates might rise, it could use an interest rate swap to effectively convert its debt into a fixed rate obligation, thereby fixing its exposure. Similarly, if business has the right to receive non-dollar denominated revenues from a foreign-based affiliate, it could use a currency swap to hedge the risk of exposure to fluctuating exchange rates.

OTC derivatives transactions can be custom tailored to meet the unique needs of individual firms. Due to the tailored nature of such transactions and their bilateral nature, and other factors, OTC derivatives differ substantially from the standardized exchange-traded futures contracts regulated by the CFTC. In a typical OTC derivatives transaction, two counterparties enter into an agreement to exchange cash flows at periodic intervals during the term of the agreement. The cash flows are determined by applying a prearranged formula to the "notional" principal amount of the transaction. In most cases, such as interest rate swaps, this notional principal amount never changes hands and is merely used as a reference for calculating the cash flows. Almost any kind of OTC derivative can be created. The flexibility and benefits that these transactions provide have led to their dramatic growth. In addition to interest rate and currency transactions, commodity, equity, credit and other types of transactions are widely used. Transactions take place around the world, but the United States has been a leader in the development of OTC derivatives transactions, and American businesses were among the earliest to benefit from these risk management tools. The dramatic growth in the volume and diversity of OTC derivatives transactions is the best evidence of their importance to, and acceptance by, end users.

While its use is a matter of choice among the parties to the transaction, almost all OTC derivatives contracts both within and outside the United States are based on a Master Agreement published by ISDA. The ISDA Master Agreement is a standard form and governs the legal and credit relationship between counterparties, and incorporates

counterparty risk mitigation practices such as netting and allows for collateralization. The ISDA Master Agreement also addresses issues related to bankruptcy and insolvency, such as netting, valuation and payment. The strength of the ISDA documentation and the important actions taken by Congress (and regulators) to ensure that OTC derivatives contracts would be enforceable in accordance with their terms have contributed positively to the ability of the financial and commodity markets to absorb events such as the Enron bankruptcy without systemic risk.

Legal Certainty and the CEA. The availability of OTC derivatives transactions within a strong legal framework is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management benefits that OTC derivatives transactions provide. One of ISDA's principal goals since its inception has been to promote legal certainty for OTC derivatives transactions.

"Legal certainty" simply means that parties must be certain that the provisions of their OTC derivatives contracts will be enforceable in accordance with their terms. For example, ISDA has sought to establish (i) clarity concerning how OTC derivatives transactions will be treated under the laws and regulations of the United States as well as many other countries; (ii) certainty that OTC derivatives transactions will be legally enforceable in accordance with their terms and not subject to avoidance; and (iii) certainty that key provisions of OTC derivatives transactions (including netting and termination provisions) will be enforceable, even in the case of the bankruptcy of one of the parties. Within the United States, until the adoption of the CFMA, the CEA was the major source of legal uncertainty with respect to OTC derivatives. As discussed below, both Congress and the CFTC have since the late 1980s acted to provide increased legal certainty for OTC derivatives.

The original version of what is now the CEA was enacted in 1922 to ensure that participants in the commodities futures markets were not defrauded and that those markets, which served significant price discovery functions, were not manipulated. To

achieve these objectives, the CEA required, and still requires, that all futures contracts on covered commodities be traded on a government-regulated futures exchange. Under this "exchange-trading requirement", all futures contracts that are not traded on a regulated futures exchange are illegal and unenforceable.

As originally enacted, the CEA applied only with respect to certain agricultural commodities. In 1974, the CEA was substantially revised by (i) establishing the CFTC as an independent agency to administer the CEA; (ii) expanding the definition of "commodity" to include (with certain exceptions) "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with"; and (iii) at the request of the Treasury Department, providing a statutory exclusion from the CEA for transactions in or involving government securities, foreign currencies and certain other similar commodities.

1989 Swaps Policy Statement. In the late 1980s, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At this time, there was a consensus that OTC derivatives were not "futures" contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA's exchange trading requirement.

To address these concerns, the CFTC issued a Swaps Policy Statement in 1989 stating its view ". . . . that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the CEA. . . ." The CFTC also established a nonexclusive safe harbor for swaps transactions that met certain requirements (e.g., that they were undertaken in connection with a line of business and not marketed to the general public). The Swaps Policy Statement provided legal certainty that the CFTC would not initiate enforcement actions with respect to OTC derivatives that satisfied the safe harbor, but it did not and could not eliminate the risk that a counterparty to an OTC derivatives contract would attempt to avoid its contractual obligations by seeking a court ruling that the contract was an illegal off-exchange "futures" contract.

Futures Trading Practices Act of 1992 (FTPA). In 1992, Congress itself took a crucial step to provide legal certainty that the CEA was not applicable to OTC derivatives by passing the FTPA. In this important legislation Congress provided the CFTC with explicit statutory authority to issue exemptions from the CEA. The purpose of granting this exemptive authority was ". . . to give the [CFTC] a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner."

In passing the FTPA, Congress specifically directed the CFTC to resolve legal certainty concerns with respect to OTC derivatives by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that any class of OTC derivatives transactions were "futures," the Congress made it very clear that granting of an exemption does not ". . . require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the [CEA]."

1993 CFTC Exemptions. In response to the FTPA, the CFTC adopted a series of exemptions. In January 1993, the CFTC issued the Swaps Exemption and an exemption for hybrid instruments. The Swaps Exemption exempted certain types of OTC derivatives, when entered into between sophisticated counterparties, from most provisions of the CEA, including the exchange-trading requirement. In general, the Swaps Exemption covered a broader range of contracts than did the 1989 Swaps Policy Statement, but some types of OTC derivatives were not covered (e.g., other provisions of the CEA precluded application of the Swaps Exemption to OTC derivatives based on securities). In April 1993, the CFTC also issued an exemption for certain contracts involving specified energy products when entered into between commercial participants. This exemption, issued after notice and opportunity for public comment, was also intended to provide legal certainty that the covered energy contracts were not subject to regulation under the CEA.

1998 CFTC Concept Release and Congressional Moratorium. Despite these efforts by Congress and the CFTC to provide increased legal certainty that most OTC derivatives were not appropriately regulated as futures under the CEA, concerns

continued to exist. These concerns proved to be neither academic nor speculative. In 1998, the CFTC issued a so-called "Concept Release" on OTC derivatives. As described by this Committee, the Concept Release

> ". . . was perceived by many as foreshadowing possible regulation of these instruments [OTC derivatives] as futures. The possibility of regulatory action had considerable ramifications, given the size and importance of the OTC market. This action [by the CFTC] significantly magnified the long-standing legal uncertainty surrounding these instruments, raising concerns in the OTC market, including suggestions it would cause portions of the market to move overseas.
>
> "This prospect led the Treasury, the Fed and the SEC to oppose the concept release and request that Congress enact a moratorium on the CFTC's ability to regulate these instruments until after the [President's] Working Group [on Financial Markets] could complete a stuffy of the issue. As a result, Congress passed a six-month moratorium on the CFTC's ability to regulate OTC derivatives." S. Rep. No. 103-390 (2000).

1999 President's Working Group Report. On November 15, 1999, the President's Working Group on Financial Markets issued its report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act.* The Report reflected an extraordinary consensus reached by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. It recommended that Congress enact legislation explicitly to clarify that most OTC derivatives transactions involving financial commodities generally are excluded from the CEA. As stated in the Report, " . . . an environment of legal certainty . . . will help reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector". Indeed, as the Report also noted, the failure to enact such legislation ". . . would perpetuate legal uncertainty and impose unnecessary regulatory burdens and constraints upon the development of these markets within the United States."

Commodity Futures Modernization Act of 2000 (CFMA). In December 2000, Congress passed the CFMA. This specific legislation was the product of more than two years of consideration. Four Committees of the Congress held hearings on and formally approved the legislation. At these hearings and elsewhere, key financial regulators (the Treasury, the Federal Reserve, the SEC and the CFTC) and other interested parties presented and debated the merits of various alternative proposals. At each stage of its consideration, bipartisan majorities approved the CFMA.

The principal purpose of the legislation was to eliminate, and not merely reduce, uncertainty with respect to the legal and regulatory status of most OTC derivatives transactions involving sophisticated counterparties. In this respect, as demonstrated by the preceding discussion, the CFMA did not mark a radical departure from prior policy. For more than a decade prior to passage of the CFMA, Congress and the CFTC had worked diligently and almost without exception to provide increased legal certainty that OTC derivatives transactions were not appropriately regulated as futures contracts under the CEA. The CFMA was therefore a culmination of a long and deliberate process to provide legal certainty for OTC derivatives and thereby reduce systemic risk and promote financial innovation.

IV.

Experience Under the CFMA

Our experience to date under the CFMA indicates that Congress did indeed achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that would both reduce systemic risk and promote financial innovation. As noted above, the increased use of interest rate, foreign currency and credit derivatives has enabled American businesses and financial institutions to manage these key financial risks more effectively during the current economic downturn than would have otherwise been possible. In addition, the development of new types of OTC derivatives to manage other types of risks, as well as the emergence of clearing proposals, is evidence that the CFMA has created a climate that fosters financial innovation.

Equally significant, three events since the passage of the CFMA have in many ways "stress tested" the OTC derivatives markets and the applicable provisions of the

CFMA itself. The results have been encouraging. First, there is no question but that the CFMA structure enabled firms to deal with the economic downturn in the early part of this decade in a more effective manner. The well publicized events leading to Enron's bankruptcy filing in December 2001 presented a second test. Enron raised serious concerns involving accounting practices, securities law disclosures and corporate governance policies. These issues received serious attention from policymakers and the Enron situation contributed to the decision of Congress to enact the Sarbanes-Oxley Act of 2002. Moreover, the CFTC and other regulators conducted intensive investigations (some of which are ongoing) and initiated a broad range of enforcement actions, including actions based on the CFMA.

ISDA also carefully considered the possible implication of the Enron collapse. In a detailed study entitled "Enron: Corporate Failure, Market Success," released in April 2002 (available on ISDA's web site), ISDA concluded that OTC derivatives did not cause, or contribute materially to, Enron's failure. Had Enron complied with accounting and disclosure requirements, it could not have built the "house of cards" that eventually led to its downfall. The market in the end exercised the ultimate sanction over Enron and the market for swaps and other OTC derivatives worked as expected and experienced no apparent disruption. The OTC derivative market did not fail to function in the Enron episode. Indeed, market participants have learned much about risk management in recent years. Considering the size of Enron, it is important to note that its failure did not have a systemic impact.

The equally well-publicized transactions of Enron and others in or with respect to the California energy market presented a third test involving different public policy questions; namely, the design of the California electricity market, the lack of adequate reserves, demand response relative to growing electricity demand and possible manipulation of the wholesale market. ISDA views any credible allegations of "manipulation" in financial or other markets as a serious matter requiring attention and therefore welcomed the investigations by the appropriate federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC) and the Department of Justice. Both FERC and the CFTC have now initiated a series of

enforcement actions employing the tools available under existing law, including the CFMA. Based on this experience, there does not appear to be any specific evidence that the Commission's antimanipulation authority is deficient.

In 2003, ISDA released a white paper entitle "Restoring Confidence in the U.S. events that led to the loss of confidence in these markets, the paper identified the regulatory framework (as enhanced by the CFMA) as one of the factors that was effective in countering the fallout from market events. As in the case of the Enron bankruptcy, the CFMA contributed to the ability of the markets to respond to a difficult situation with potentially broad ranging impact.

IV.

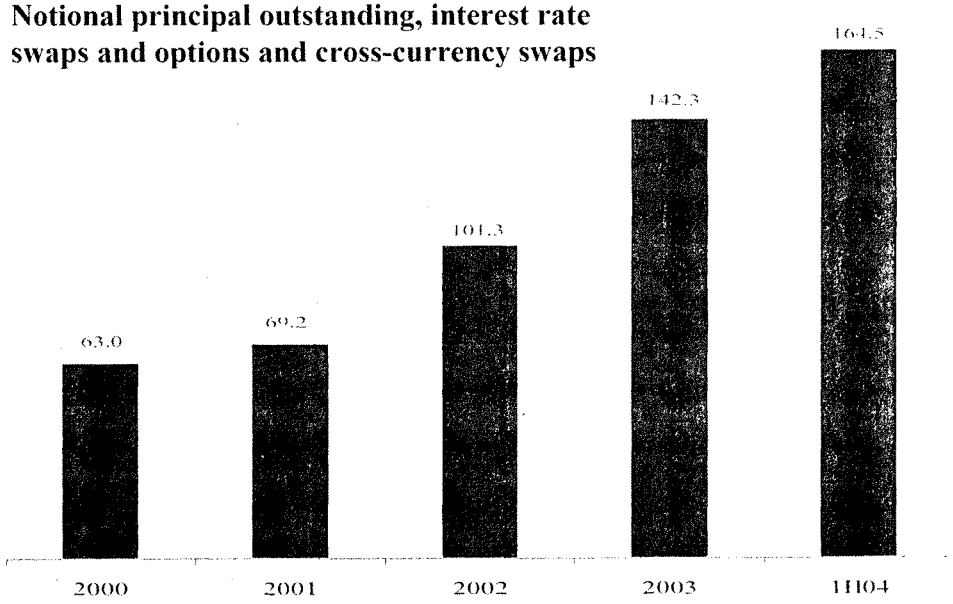
Conclusion

OTC derivatives are a considerable contributor to the flexibility and resiliency of our financial system. They allow businesses, financial institutions, governmental entities and other end users to manage the financial, commodity, credit and other risks inherent in their core economic activities in an efficient manner. The CFMA provide legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts. This policy, now codified in the CFMA, materially reduces systemic risk and encourages financial innovation. The economic downturn at the beginning of this decade, and the manner in which the OTC derivatives markets functioned in the case of the collapse of Enron and the California energy market situation, have, together with the enforcement actions of the CFTC under the CFMA, confirmed that the policy judgments Congress made in 2000 were sound then and remain so today.

EXHIBIT 1

Derivatives growth, 2000-2004

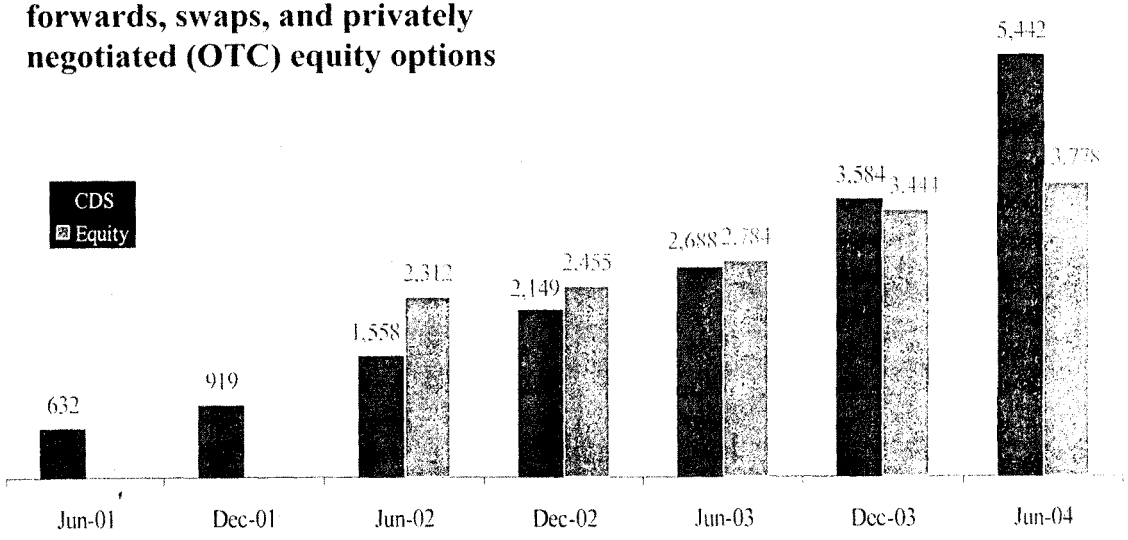
Notional principal outstanding, interest rate swaps and options and cross-currency swaps



Source: International Swaps and Derivatives Association

Credit default swaps and equity derivatives

Equity derivatives include equity forwards, swaps, and privately negotiated (OTC) equity options



Source: International Swaps and Derivatives Association

WRITTEN STATEMENT

OF

OLIVER I. IRELAND

ON BEHALF OF

HUNTSMAN CORPORATION

AND

INDUSTRIAL ENERGY CONSUMERS OF AMERICA

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION,

AND FORESTRY

UNITED STATES SENATE

Good morning Chairman Chambliss, Ranking Member Harkin, and Members of the Committee. I am a partner in the law firm of Morrison & Foerster LLP, and practice in the firm's Washington, D.C. office. I previously served as Associate General Counsel to the Board of Governors of the Federal Reserve System and, in that capacity, advised the Board on a wide range of matters relating to the Commodity Exchange Act ("Act"), and other issues regarding the regulation of derivative transactions. I am appearing before the Committee on behalf of the Huntsman Corporation ("Huntsman"), which is a member of the Industrial Energy Consumers of America. I thank you and the Members of the Committee for the opportunity to participate in today's hearing on the reauthorization of the Commodity Futures Trading Commission ("CFTC").

I would like to bring to the Committee's attention the important issues relating to the regulation of the natural gas futures contracts markets.

Huntsman is a global leader in the chemical manufacturing industry. Its operating companies manufacture basic products for a variety of global industries, including chemicals, plastics, automotive, agriculture, and others. Today, Huntsman employs over 11,000 men and women in 63 operations located in 22 countries. As this Committee is well aware, global manufacturing companies like Huntsman depend on the commodities markets for their materials and rely on fair pricing in those markets in order to be competitive both domestically and abroad. A key commodity for Huntsman, as well as thousands of other domestic businesses and millions of farmers and consumers, is natural gas.

In enacting the Commodity Futures Modernization Act of 2000 ("CFMA"), Congress amended the Act in significant ways. First, the regulation of contract markets was streamlined based on "core principles" designed to ensure fair and equitable trading for market participants across a variety of contracts. Second, the shadows of legal uncertainty that fell on much of the over-the-counter derivatives market were eliminated, enabling sophisticated market participants to appropriately negotiate and trade instruments that suit their needs. We would generally concur with CFTC Chair Brown-Hruska that the Act, as amended, "functions exceptionally well."

However, price volatility in the natural gas contracts markets since mid-2000 suggests that the market for natural gas futures contracts is not operating efficiently and, therefore, that the regulatory framework that applies to natural gas should be reviewed.

To be clear, we recognize that the marketplace for natural gas is complex, and that prices are influenced by numerous supply and demand factors. In her testimony, CFTC Chair Brown-Hruska referred to the "recent run-ups in prices in natural gas" as one of the factors cited in calls to increase the CFTC's authority to generally regulate trading in the "energy sector." I will focus on the somewhat narrower issue of increased *price volatility* in the natural gas futures contracts markets. This development is appropriately within the domain of this Committee and the CFTC, and threatens to undermine the stability and confidence in the futures markets for natural gas.

The market for natural gas will operate most effectively when the price of natural gas is shaped by fundamental forces of supply and demand. This price will allocate supplies of gas within the economy most effectively, thereby benefiting producers, users of natural gas and the economy as a whole. Facilitating this pricing function is one of the key purposes of the Commodity Exchange Act. However, if this pricing process breaks down, that breakdown can result in inappropriate pricing and allocation of natural gas to the detriment of producers, users and the economy as a whole.

Price volatility, which can be generally defined as the movement between prices over a stated period of time, is an important characteristic of the commodities futures markets. Price volatility reflects necessary uncertainty about the changes in future prices. Although movements in futures contracts markets can be largely due to genuine uncertainty about supplies relative to expected demand, high levels of price volatility also may reflect trading activity that is unrelated to fundamentals of supply and demand and can impair the price discovery function of contract markets.

We believe that there is evidence that the level of price volatility in the futures market for natural gas is impairing, rather than promoting, pricing in the market for natural gas. Since the CFMA was enacted, day-to-day price volatility in the natural gas futures contracts traded on the New York Mercantile Exchange ("NYMEX") has increased substantially, even after taking into account the higher prices overall in the prices for natural gas during this period. By some measures, price volatility in the natural gas contracts traded on the NYMEX has increased by 60%. We note that during this same period, commercial-trading participants on the NYMEX, that is, participants who buy and sell natural gas for use in the real economy and trade in futures contracts to hedge their transactions in the cash markets, have declined to a relatively small percentage of the market participants.

We believe that the increased price volatility raises questions as to whether the trading in the natural gas contracts may be susceptible to deceptive or manipulative practices. We applaud the efforts that the CFTC has taken thus far to respond to recent unlawful acts in the markets for contracts involving natural gas. CFTC Chair Brown-Hruska correctly observed that the CFTC has acted resolutely in these markets and that its authority to prosecute those who commit fraudulent or manipulative acts is significant. However, we believe that the Committee should consider additional measures to augment the authority of the CFTC to address issues related to natural gas contracts, including the potential for manipulation.

In particular, we believe that the Committee should consider implementing four basic changes to the Act, each of which would facilitate greater transparency in trading and, thereby, promote more efficient pricing based on open and fair competition.

Treat Natural Gas as an Agricultural Commodity

First, the Committee should consider amending the Act so that trading that involves natural gas is regulated under the same rules that apply to agricultural commodities. As Dr. James Newsome, President of the NYMEX, correctly noted, Congress has provided in the Act, as amended, "various market tiers" so that a marketplace can select its appropriate level of regulation according to the product type offered. We believe that the cash market for natural gas more closely resembles the cash market for agricultural commodities than the markets for financial instruments.

CFTC Review of Natural Gas Contracts

Second, the Committee should consider requiring the CFTC to review and seek public comment on *existing* rules for natural gas contracts and determine whether each rule that currently applies to natural gas is consistent with the "core principles" established in the Act. We believe that, going forward, the CFTC also should apply this process to *future changes* to rules for contracts involving natural gas, as proposed by the relevant contract market. This greater scrutiny of rules regarding natural gas contracts would help to ensure their consistency with the core principles.

For example, we believe that the current rules in place on the NYMEX relating to the maximum limits on the daily price fluctuation, sometimes known as "circuit breakers," for trading in natural gas contracts impose no practical limits. While we recognize that circuit breakers are a controversial issue, we believe that circuit breakers can provide important time for markets to evaluate new information and to act appropriately, therefore promoting the price discovery function. We believe that a circuit breaker in excess of eight (8) percent, in either direction, should be reviewed particularly carefully for consistency with the core principles. This threshold would be similar to the circuit breakers that were in place on the NYMEX in early-year 2000 before price volatility began to increase.

Large Position Reports

Third, the Committee should consider amending the Act to give the CFTC back-up authority to require any person holding large positions in natural gas contracts either on contract markets, or in the over-the-counter markets, or large quantities of natural gas, to file reports regarding those positions or quantities. Any holding or position that otherwise is required to be reported to any U.S. government agency should be exempt if that report would be made available to the CFTC upon request. The CFTC also should be authorized, but not required, to prescribe recordkeeping requirements as appropriate to determine that persons subject to the requirements to file reports are complying with such reporting requirements.

The CFTC would be expected to use these authorities sparingly, taking into consideration the burden that they may impose, as well as their utility in detecting or deterring manipulations.

Cash Settlement of Natural Gas Contracts

Fourth, the Committee should consider amendments to the Act that provide additional authority for the CFTC to prescribe rules for cash settlement of natural gas contracts, instead of physical delivery, to combat manipulation in prices of those contracts. Appropriate rules for cash settlement could help to deter and even break short squeezes on contract markets. These rules would apply only to circumstances where market conditions suggest the possibility of manipulation.

Thank you for the opportunity to be here today. I would be happy to address any comments that the Committee may have.

TESTIMONY OF DANIEL J. ROTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
U.S. SENATE

MARCH 10, 2005

My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Chambliss and members of the Committee for this opportunity to appear here today to present our views on some of the issues facing Congress as it begins the reauthorization process. NFA is the industry-wide self-regulatory organization for the U.S. futures industry. Regulation is all we do at NFA—we do not operate a marketplace and we are not a lobbying organization. As a regulator, NFA is first and foremost a customer protection organization. Our mission is to provide the futures industry with the most effective and the most efficient regulation possible.

Our approximately 4,000 Members include futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). We also regulate approximately 54,000 registered account executives who work for our Members. As a regulator, NFA's main responsibilities are many and varied. We establish rules and standards to ensure fair dealing with customers; we perform audits and examinations of our Members to monitor their compliance with those rules; we conduct financial surveillance to enforce compliance with NFA financial requirements; we provide arbitration and mediation of futures-related disputes; we perform trade practice and market surveillance activities for a number of exchanges; and we conduct extensive educational programs both for the investing public and for our Members. We also perform a number of regulatory functions on behalf of the CFTC, including the entire registration process—from screening applicants for fitness to taking actions to deny or revoke registrations when those fitness standards are not met. We perform these duties with a staff of approximately 235 people and a budget of over $32 million, all of which is paid by the futures industry.

The process of self-regulation has been the subject of a great deal of criticism over the last several years. The problems in the securities industry have been well publicized to say the least and have led some, including New York Attorney General Elliot Spitzer, to label self-regulation "an abysmal failure." Less well publicized is the tremendous track record that self-regulation has achieved in the U.S. futures industry. Since NFA began operations in 1982, volume on U.S. futures markets has increased by over 1,200%—a great testament to the innovation and value of our futures markets. What most people don't realize is that during that same time period customer complaints in the futures industry are down by almost 75%. In 1982 the CFTC received

over 1,000 customer complaints in its reparations program. Last calendar year the CFTC received just 93 complaints. Even when you add the 158 cases filed with NFA's arbitration program, the reduction in customer complaints is dramatic.

That dramatic drop was not an accident. NFA has worked in very close partnership with the CFTC and the futures exchanges to make sure that we are allocating resources where they are most needed, that we do not duplicate each other's efforts and that precious regulatory resources are not squandered. Self-regulation, both by NFA and the futures exchanges, has served this industry very well for a very long time. That's not to say that any of us can rest on our laurels or that the self-regulatory process is perfect.

Obviously, the industry is changing rapidly, and as it changes, the conflicts of interest inherent in the self-regulatory process may change as well. As futures markets all over the world grow more and more competitive, the need to ensure that the self-regulatory process remains above the competitive fray grows too. The CFTC's job of overseeing the self-regulatory process may become more sensitive and more complicated. We have every confidence, though, that the CFTC will continue to monitor self-regulation carefully so that self-regulation in the futures industry will continue to merit the confidence that it has earned.

In the last reauthorization process, Congress made bold changes to the Commodity Exchange Act. The Commodity Futures Modernization Act rejected a highly prescriptive, outmoded approach to regulation in favor of a more flexible approach that focused regulatory protections where they were most needed. I am pleased to join the rest of the industry in noting the great success of the CFMA and the superb work of the CFTC in implementing exactly the kind of flexible regulatory approach that the CFMA envisioned. The Commission and its staff have worked to reduce unnecessary and costly regulatory burdens for every segment of the industry while preserving the highest level of customer protection. The Commission has also followed the mandate of the CFMA to maximize efficiency by delegating more day-to-day, front line regulatory responsibilities to NFA. In January 2003, the Commission delegated to NFA the authority to conduct reviews and analyses of annual financial reports filed by CPOs. Additionally, in March 2003, the CFTC authorized NFA to conduct reviews of disclosure documents for publicly-offered commodity pools. Each of these recent delegations has been performed by NFA in a high-quality and expeditious manner. In making these delegations, the Commission has been able to free up its own valuable resources to apply them to areas demanding attention.

Though the CFMA has been a great success, it failed in one of its objectives that directly impacts customer protection. In the CFMA Congress attempted to resolve the so-called Treasury Amendment issue once and for all by clarifying that the CFTC does, in fact, have jurisdiction to protect retail customers investing in foreign currency futures. The basic thrust of the CFMA in this area was that foreign currency futures with retail customers were covered by the Act unless the counterparty was an "otherwise regulated entity," such as a bank, a broker-dealer or an FCM. Unfortunately,

as we sit here today, there is as much uncertainty over the CFTC's authority to protect retail customers as there was five years ago. This uncertainty is clearly not what Congress intended in passing the CFMA.

The main problem stems from a decision in the Seventh Circuit Court of Appeals in a forex fraud case brought by the CFTC, the so-called Zelener case. In Zelener, the District Court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures. The Seventh Circuit affirmed that decision. The "rolling spot" contracts in Zelener were marketed to retail customers for purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In Zelener, though, the Seventh Circuit based its decision that these were not futures contracts exclusively on the terms of the written contract itself. Because the written contract in Zelener did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures.

Zelener creates the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals can sell retail customers contracts that look like futures, act like futures and are sold like futures and can do so outside the CFTC's jurisdiction. To make matters worse, the rationale of the Zelener decision is not limited to foreign currency products. Similar contracts for unleaded gas, heating oil, agricultural products or virtually any other commodity could be sold to the public in an unregulated environment.

I recognize that Zelener is just one case, and we should not overreact to it. It's true that the Zelener decision would allow the CFTC in other cases to present evidence that the FCM made oral representations about the customer's right to offset. But the reality is that in most cases the sales pitch is not made by the FCM but by an unregistered, unregulated solicitor. It's not clear to me that any court would find that the nature of the contract between the customer and the FCM was transformed into a futures contract because of oral representations made by some third party. In my opinion, trying to work our way out of the Zelener problem through future enforcement actions puts an awful lot of chips on a bet that's no sure thing.

The bottom line is that the Zelener decision makes it much harder for the Commission to prove that contracts sold to retail customers to speculate in commodity prices are futures, makes it easier for the unscrupulous to avoid CFTC regulation and creates a real, live customer protection issue. Unsophisticated retail customers are going to be victimized by high-pressured sales pitches for futures look-alike products covering everything from foreign currencies to precious metals to heating oil and to any other commodity known to man. These retail customers are the ones who most need regulatory protection and that protection should not be stripped from them because a clever lawyer finds a loophole in the law.

It's NFA's view that Congress should address this issue. It may not be easy. The issues can be both sensitive and complex. We would want to ensure that any legislative response would not have unintended consequences. But just because it's hard doesn't mean that it can't be done. I am sure it would be helpful for this Committee to review a specific proposal to address this issue. NFA is working closely with the Commission and the industry to develop such a proposal for your consideration.

Unfortunately, the Zelener decision is not the only problem we have encountered with retail forex. Since passage of the CFMA, a number of firms—that do not engage in any other regulated business—have nonetheless registered as FCMs to qualify to be an otherwise regulated entity and have become NFA Forex Dealer Members for the sole purpose of acting as counterparties in these transactions. For example, just eighteen months ago, NFA had 14 active Forex Dealer Members and those Members held approximately $170 million in retail customer funds. Since then, the retail forex business has continued to grow by leaps and bounds. Today, NFA has 28 active Forex Dealer Members holding over $520 million in customer funds. That growth has not been problem free.

Though relatively few in number, forex dealers have accounted for 50% of our emergency enforcement actions and over 20% of our arbitration docket. I know the CFTC has been very aggressive in enforcement cases involving forex, though most of those cases have involved unregistered firms. Obviously, retail forex has consumed a good deal of resources at NFA, but we are committed to doing whatever it takes to get our job done. We have appointed a blue ribbon committee to review all of our forex rules. Just two weeks ago, our Board passed additional rules to strengthen both our financial requirements and sales practice rules regarding forex. We will continue to enforce our rules vigorously and bring actions whenever necessary to ensure compliance with our rules. Part of the problem, though, is that some firms can operate beyond our reach, in a completely unregulated environment because of a glitch in the wording of the CFMA.

As I mentioned before, the basic thrust of the CFMA was that only "otherwise regulated entities" could offer retail customers off-exchange foreign currency futures. Unfortunately, the wording of the statute only requires the counterparty to be an otherwise regulated entity. This creates the possibility that an FCM, for example, might be the counterparty but the firm that actually does the telemarketing for these products is completely unregistered and unregulated. There are literally hundreds of these unregulated firms doing telemarketing of off-exchange forex transactions to retail customers and in some instances the people making the sales pitches have been barred from the futures industry for sales practice fraud. I don't think that's what Congress intended at all and NFA would support an amendment to Section 2(c) of the Act to make clear that not only the counterparties but also the persons actually selling these products to retail customers must be "otherwise regulated entities."

There's one more forex problem I should mention, though we are hopeful that it's a problem we can solve through NFA rules without any further legislation from Congress. Section 2(c) of the CEA could be read to allow unregulated affiliates of FCMs to act as counterparties to retail customers if the FCM makes and keeps records of the affiliates under the CEA's risk-assessment provisions. Some firms have tried to take advantage of this provision of the Act by creating "shell" FCMs. These shell FCMs do not do any futures business and they do not do any retail forex business. Their sole reason for existence seems to be to create affiliates that do retail forex business in a completely unregulated environment.

I don't think that that's what Congress had in mind. Neither does the CFTC. The Commission has a pending enforcement action against one affiliate in which it alleges, among other things, that the affiliate does not qualify under the CFTC's risk-assessment provisions. A ruling in the CFTC's favor would, in part, require FCMs with retail forex affiliates to maintain $5 million in adjusted net capital. However, since that case may take some time to work its way through the federal court system, NFA's Board recently adopted a rule raising the minimum capital requirement for FCMs with retail forex affiliates from $250,000 to $5 million. We hope these efforts will solve the shell FCM problem without the need for legislative relief.

Another issue that Congress should be aware of, though we are not seeking amendments to the Act, involves the SEC's recent rulemaking that requires advisors of certain hedge funds to register under the Investment Advisers Act of 1940. Coordination among regulators has always been vital to avoid duplication of effort and the squandering of regulatory resources. With the SEC rulemaking, there's a real danger of duplication of effort regarding the CPOs and CTAs that are already regulated by the CFTC and NFA. Such duplication drains regulatory resources that are already oftentimes stretched too thin.

According to recent rankings by *Institutional Investor,* eighteen of the top 25 and 63 of the top 100 hedge fund complexes are operated by NFA Member CPOs or their affiliates. In fact, most of the prominent names in the hedge fund business are NFA Members. NFA already has extensive regulatory programs in place for all of its CPO and CTA Members, including regular audits and review of financial statements, disclosure documents and promotional material. Though we focus on futures-related activity, our review of our CPO financial records includes information on non-futures related investments. Overall, the CFTC/NFA regulation of CPOs and CTAs has been an unqualified success. CPOs and CTAs comprise 60% of NFA's membership but are named in only 20% of NFA's enforcement actions and in only 2% of customer complaints. If the SEC, the CFTC and NFA all end up regulating some of the same funds, that doesn't seem to be the smartest use of regulatory resources. We hope the CFTC and the SEC can work together to make the regulatory process as efficient as possible and we will do everything we can to help that process. Frankly, however, given our experience with security futures products, we are skeptical that regulatory efficiency can be achieved through cooperation between these agencies. We urge this Committee to use its oversight function to ensure that cooperation occurs, and if you are

not satisfied with the level of cooperation, then we encourage you to consider a legislative response to this issue. We, of course, are willing to work with you in developing such a response if necessary.

One more area in which we can avoid duplication of effort would require Congressional action. The Act requires the CFTC to operate a reparations program to handle the resolution of disputes between customers and CFTC registrants. The program made a lot of sense when it was established almost 30 years ago, but the world is a much different place now. The CFTC and NFA have cracked down on sales practice fraud and NFA's arbitration program has grown and matured as an informal alternative to reparations. The impact of all these changes on the reparations program has been dramatic. In 1982, before NFA began operations, there were 1,079 cases filed with the Commission. As previously noted, last calendar year there were 93, compared with 158 arbitration cases filed at NFA. Simply stated, the reparations program has outlived its usefulness and we see no reason why the CFTC should be the only federal regulatory agency that maintains a dispute resolution forum. NFA would support an amendment to the Act to eliminate the reparations program.

In closing, let me state that NFA believes the industry and the public have benefited greatly from the enlightened regulatory approach that Congress adopted in the CFMA. We are proud of the efficiency we have brought to the regulatory process and are confident that the amendments we suggest above will further improve both customer protection and regulatory efficiency. We look forward to working with this Committee and with the industry to address the issues outlined above.

MANAGED FUNDS ASSOCIATION

TESTIMONY

OF

JOHN G. GAINE
PRESIDENT
MANAGED FUNDS ASSOCIATION

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

OF THE

UNITED STATES SENATE

FOR A HEARING ENTITLED:
"REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION"
MARCH 10, 2005

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Testimony of John G. Gaine, President, Managed Funds Association
Before the Committee on Agriculture, Nutrition, and Forestry
United States Senate
March 10, 2005

Mr. Chairman and Members of this Committee, my name is John G. Gaine and I am the President of Managed Funds Association ("MFA"). MFA appreciates the opportunity to provide testimony for the Committee's consideration in connection with the reauthorization of the Commodity Futures Trading Commission (the "Commission" or the "CFTC"). I testified yesterday on behalf of MFA before the General Farm Commodities and Risk Management Subcommittee of the House Committee on Agriculture concerning CFTC reauthorization so my testimony today will reiterate MFA's views on this subject.

We commend the Committee for this timely hearing and for its leadership during the last reauthorization process, which ultimately led to the adoption of the Commodity Futures Modernization Act of 2000 ("CFMA"), a law we believe has served our industry and the U.S. capital markets extremely well. The CFTC equally deserves significant credit for a steady, sensible hand in implementing the CFMA for the past four years. Because of the many positive aspects of this law, as I will explain in my testimony, MFA is not advocating any statutory change at this time. If Congress does decide to change the existing law, we believe it should do so carefully while preserving the ideals of the CFMA.

About MFA

MFA is the primary trade association representing professionals who specialize in the management of alternative investments, including hedge funds, funds of funds and managed futures funds. MFA has over 850 members, including representatives of 35 of the 50 largest hedge fund groups in the world. Our members, many of whom represent firms that are registered with the CFTC as commodity trading advisors ("CTAs") and commodity pool operators ("CPOs"), manage a substantial portion of the over $1 trillion invested in alternative investment products globally.

MFA has been a vocal advocate for sound and sensible public policy in this important sector of the financial world—a sector that provides many benefits to the global marketplace. Our members offer investors the ability to diversify their portfolios in a meaningful way by providing investment products that perform in a manner that is not correlated to the performance of more traditional stock and bond investments. These alternative investment vehicles provide liquidity to the futures and other markets, which serves to increase the efficiency of the price discovery and hedging functions of these markets.

As major customers of futures exchanges, futures commission merchants as well as other futures industry services, many of MFA's members directly benefit from the provisions of the Commodity Exchange Act (the "CEA") and, in particular, the modernizations brought about by the CFMA. The Commission's oversight of the functioning of and participation in futures markets has an important impact on CPOs, CTAs and their clients. Furthermore, many aspects of MFA members' business operations (such as sales, promotional, registration and operational activities) are also subject to regulation by the National Futures Association ("NFA") —the industry's self-

regulatory organization. The Commission and the NFA oversee the business activities of CPOs and CTAs through registration, disclosure, anti-fraud, recordkeeping and reporting requirements. Each of the futures exchanges also monitors the trading activities of our members in their respective markets.

Many of MFA's members are subject to regulation under other federal legislation in addition to the CEA. The public offer and sale of interests in commodity funds are subject to the Securities Act of 1933 (the "1933 Act"), which requires registration of these interests and mandates certain disclosure obligations. Commodity funds are also subject to the Securities and Exchange Act of 1934, which requires the filing of certain publicly-available reports and finally to the individual securities laws of each of the 50 states. Moreover, under the Investment Advisers Act of 1940 ("Advisers Act"), most hedge fund managers will soon be required to register with the Securities and Exchange Commission ("SEC") as investment advisers. MFA's members also will be subject to the anti-money laundering requirements of the USA PATRIOT Act of 2001.

Since the last reauthorization in 2000, MFA has worked together with the CFTC on a number of important rulemaking projects. We believe the CFTC's efforts at reducing unnecessarily burdensome regulations, also a direct result of the CFMA, will continue to encourage greater use of futures products in the financial marketplace. Accordingly, we are delighted to be here today to discuss the importance of the CFTC and the statutory framework under which it operates to our industry.

MFA's Response to Industry Developments

MFA has undertaken a number of private sector initiatives to promote the integrity, safety and soundness of alternative investments. Some Committee Members may recall that in 1998, after the near-collapse of Long Term Capital Management, both the public and private sectors focused upon ways to reduce systemic risk in alternative investment vehicles. In 1999, one notable public sector response was the report published by the President's Working Group on Financial Markets entitled, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (the "PWG Report"). The PWG Report recommended a number of measures, both public and private, designed to enhance market discipline in constraining excess leverage. Specifically, the PWG Report recommended that hedge funds establish a set of sound practices for their risk management and internal controls. In February 2000, "Sound Practices for Hedge Fund Managers" ("Sound Practices") was published as an industry response to this recommendation.

MFA believes that the public and private sector measures implemented in the aftermath of LTCM, such as those described in the "Sound Practices," have successfully reduced the exposure of global financial markets to systemic risk. As a testament to this belief, MFA updated these "Sound Practices" in 2003 and is in the process of drafting another substantial update of this document for 2005. Similarly, in the anti-money laundering context, before it was clear that hedge funds would be subject to the PATRIOT Act, MFA published its "Preliminary Guidance for Hedge Funds and Hedge Fund Mangers on Developing Anti-Money Laundering Programs" ("Preliminary Guidance") in early 2002. Both the "Sound Practices" updates as well as the "Preliminary Guidance" are clear examples of MFA's work to respond to the goals of

Congress and regulatory agencies of promoting the integrity of financial markets and their participants.

Benefits of the Alternative Investment Industry

Increased interest in and use of alternative investments is a direct result of the growing demand from institutional and other sophisticated investors for investment vehicles that deliver true diversification and help them meet their future funding obligations and other investment objectives. Our members' funds perform a number of important roles in the global marketplace, including contributing to a decrease in overall market volatility, acting as "shock absorbers" and liquidity providers by standing ready to take positions in volatile markets when other investors choose to remain on the sidelines. Fund activity also provides markets with price information, which translates into pricing efficiencies, and assists in identifying pricing inefficiencies or trouble spots in current markets. Moreover, these funds utilize state-of-the-art trading and risk management techniques that foster financial innovation and risk sophistication among market participants.

Hedge Funds Effect on Energy Markets

Energy markets enjoy all of these described benefits provided by the alternative investment industry. However, there has been increasing discussion about hedge funds and their effect on the energy markets, including recently expressed interest from Members of Congress. Some market participants have argued that price swings and volatility in these markets are a result of the impact of speculative futures trading by hedge funds. Recently questioned on this topic, both the CFTC and the Federal Energy Regulatory Commission ("FERC") generally concluded that the fundamentals of free market behavior as opposed to trading activity by hedge funds drive the prices of natural gas futures. The CFTC stated "it does not believe that hedge funds are the major source of price volatility in the natural gas market."

We believe the CFTC is doing an excellent job in overseeing the energy trading market. As Acting Chairman of the CFTC Brown-Hruska recently noted, the CFTC staff is routinely in contact with staff at FERC to exchange information about natural gas futures and cash market activity. Any unusual market developments or potential concerns about contracts traded on the futures exchanges, including natural gas contracts, are reported at regular weekly surveillance briefings at the CFTC. Additionally, CFTC economists monitor prices and price relationships in and between the futures and cash markets for natural gas, with the objective of determining if there are price distortions and evidence of manipulation. Furthermore, given the unprecedented level of CFTC enforcement actions in the energy markets over the past two years, which includes assessments of approximately $300,000,000 in penalties, we believe the agency has shown just how prudent and aggressive it can be when it comes to pursuing wrongdoing in the marketplace. The industry, including MFA members who trade in these markets, benefit from appropriate regulatory actions since these actions promote fair and efficient pricing in the marketplace.

MFA is comfortable that this issue has been, and continues to be, appropriately monitored and that the CFTC, FERC and New York Mercantile Exchange each have correctly recognized that hedge funds are not dominating energy trading and are not the

cause of price swings in the energy market. Rather, as previously discussed, hedge funds have the positive effect of increasing available liquidity and decreasing overall market volatility.

Avoidance of Duplicative Regulation

The Congressional intent of the CFMA is to avoid instances of unnecessary overlapping regulation between federal agencies and the consequent duplicative compliance costs. Our concern focuses on those hedge fund advisors registered with the CFTC as CTAs and CPOs that will now be required to also register with the SEC as investment advisers. A potential means of stemming duplicative federal agency oversight would be to define the word "primarily" as it is used in Section 203(b)(6) of the Advisers Act and in Section 4m(3) of the CEA. Under the Advisers Act, a CTA registered with the CFTC is excluded from the requirement to register with the SEC if his or her business "does not consist *primarily* of acting as an investment adviser." A parallel exclusion from the requirement to register with the CFTC exists under the CEA for investment advisers that are registered with the SEC and "whose business does not consist *primarily* of acting as a CTA." We believe the SEC and the CFTC should undertake to define the criteria a CTA or registered investment adviser must meet to exempt them from dual registration. Our members would greatly benefit from interpretive relief or guidance in this area. We ask this Committee, through your oversight authority, to encourage these two federal agencies to work together on this and other duplicative provisions so that compliance obligations are not redundant or overly burdensome. MFA is available to provide any assistance in this matter that is helpful to the process.

Importance of the CFMA

I testified before Congress in support of the bill that became the CFMA, and we continue to be a strong supporter of the law. Its passage in December 2000 represented a landmark legislative accomplishment that set the groundwork for the regulatory structure governing today's futures industry and led to unprecedented industry growth. The alternative investment industry also has seen significant growth over the past four plus years, due in no small part to the passage of the CFMA.

One of the central themes of the last reauthorization was the deregulation of exchanges, which has led to increased competition on a product-by-product basis. These changes have yielded dramatic benefits to investors, which we believe should continue to be the focus of the Commission reauthorization process and all future regulation and legislation initiatives in the alternative investment industry. The CFMA provided the foundation for the advancements we have seen in the futures industry over the past few years, as I will discuss below.

CFTC Registration Exemptions

During 2002-2003, the Commission modernized the following key rules that have significantly impacted MFA members who are CPOs and CTAs:

Rule 4.13(a)(4): This rule, proposed by MFA, provides an exemption from registration with the Commission for CPOs that operate hedge funds limited to individuals that are "qualified eligible persons" under CFTC Rule 4.7 (generally with an investment portfolio of at least $5 million) or limited to institutional investors that are at

least "accredited investors" as defined in Regulation D of the 1933 Act (generally, an individual person with a net worth of $1 million or an annual income in excess of $200,000). This rule helped to better coordinate the CEA exemptions with those available under 3(c)(7) of the Investment Company Act of 1940 and the 1933 Act. There is a corresponding CFTC exemption for CTAs that advise pools exempt under Rule 4.13(a)(4).

Rule 4.13(a)(3)(De Minimis Exemption): The CFTC adopted this registration exemption for fund managers that engage in limited ("de minimis") commodity interest trading. The exemption provides for a CPO registration exemption for fund managers that: (i) engage in only a "de minimis" amount of futures trading, under one of two alternative quantitative constraints, and (ii) sell only to "accredited investors." This exemption helps to alleviate the burden of registration on hedge fund managers who use futures or options on futures only for hedging or in other very limited ways that are incidental to their securities trading.

Rule 4.5: This rule broadens the scope of the exclusion from the definition of CPO available to otherwise regulated "Qualifying Entities" (i.e., mutual funds, pension plans, insurance company separate accounts, bank trusts funds and similar otherwise regulated institutions) by eliminating the requirement that Qualifying Entities limit their commodity interest positions to a certain percentage of their overall portfolio.

MFA believes that the exemptions discussed above represent crucial relief for Commission registrants and have led to greater use of financial and commodity futures products in the financial marketplace. Prior to their adoption, many private pooled investment vehicles avoided using commodity futures and options in their trading because of the associated CPO registration requirement. The elimination of this requirement for certain funds has encouraged the growth of the futures industry as a result. We commend the CFTC for its efforts in implementing these exemptions, which we believe were important modernizations undertaken in accordance with the principles of the CFMA.

Notional Funds

With respect to performance data of notionally funded accounts, MFA supported the CFTC's decision to permit CTAs to use nominal account size as the basis for computing a client's rate of return rather than actual funds under a CTA's control. This 2003 amendment provides a uniform basis for all CTAs to present rate-of-return and allows for a more meaningful comparison of CTAs' performance results.

Bunched Orders

Also in 2003, MFA successfully worked with the CFTC and other relevant parties to adopt a fair and effective bunched order allocation structure for a broader class of account managers and customers of bunched accounts. By allowing all customers the opportunity to have their orders bunched, customers may receive better execution and better pricing of their orders.

Speculative Limits

Speculative position limits for futures contracts on various agricultural commodities has been an issue discussed at the CFTC for many years. Most recently, the CFTC requested comments on the Chicago Board of Trade's (CBOT) proposals for either the repeal or expansion of federal speculative limits applicable to certain agricultural futures and option markets under Commission Regulation 150.2.

MFA and its Members support the liberalization of federal speculative limits, and therefore urge this Committee to support the CFTC in moving forward on this issue. Core Principle 5 of Section 5(d) of the CEA, applicable to designate contract markets, deals with Position Limitations or Accountability, and states that:

> To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary or appropriate.

Although the Commission retains the authority to set speculative position limits pursuant to Section 4a(a) of the CEA, the most recent pronouncement of Congressional intent, as set forth in the CFMA's Core Principles, squarely places responsibility for establishing position limits upon the exchanges. Therefore, we believe adoption of this proposal is consistent with the spirit and flexibility embodied in the CFMA, and will ultimately give futures exchanges the necessary tools to respond quickly to market conditions through speculative position limit adjustments.

Conclusion

MFA supports Congressional review and evaluation of the CFTC and the regulatory framework governing the U.S. futures markets. We believe it is beneficial to periodically examine federal agencies to determine whether their operations are meeting current policy objectives. At this time, MFA is not advocating any change to the Commodity Exchange Act or the CFTC's existing authority thereunder. We believe that the progress that was made since the 2000 reauthorization has permitted the alternative investment industry to continue its astounding growth as a vital component of the global financial marketplace. If Congress does elect to consider making any modifications, including changes to the CFTC's enforcement authority in light of the *Zelener* case, we hope that it will be mindful of preserving the ideals of the CFMA and the progress made through its adoption in modernizing the legal and regulatory framework under which the agency and our U.S. futures markets operate.

MFA hopes that the Commission will continue to implement the CFMA's goals by undertaking to harmonize the SEC and CFTC rules governing hedge funds and public commodity pools and by liberalizing federal speculative limits. Overall, MFA believes that the Commission has demonstrated its willingness to solicit and actively consider suggestions and proposals by industry participants that will lead to greater modernization, efficiency and innovation in the futures industry. I look forward to answering any questions you might have.

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March 10, 2005

Statement of
Micah S. Green, President
The Bond Market Association

Before the
Committee on Agriculture, Nutrition and Forestry
United States Senate

The Honorable Saxby Chambliss
Chairman

Hearing on
The Reauthorization of the Commodity Futures Trading Commission

The Bond Market Association (TBMA) is pleased to present this testimony on issues related to the reauthorization of the Commodity Futures Trading Commission (CFTC). Through our offices in New York, Washington and London, the Association represents the $44 trillion global bond markets. Our members include securities firms and banks that underwrite and trade fixed-income securities and related derivative products. The Association also represents the interests of the securitization industry through our Mortgage-Backed Securities and Securitized Products Division and our affiliated organizations, the American Securitization Forum and the European Securitization Forum. Another affiliated organization, the Asset Managers' Forum, represents the interests of institutional bond investors.

TBMA members include all 23 of the primary dealers in U.S. Treasury securities, as recognized by the Federal Reserve Bank of New York, in addition to all major dealers in federal agency bonds as well as mortgage-backed, corporate and municipal securities. Our members are also active in the markets for over-the-counter (OTC) financial contracts involving forward payments or deliveries relating to a variety of fixed-income securities, interest rates and credit products. These include swaps, repurchase agreements (repo) and forward delivery contracts.

TBMA participated actively in the debate that led to the enactment of the Commodity Futures Modernization Act of 2000 (CFMA). At that time, we advocated several changes to the CEA that were viewed as critical to vibrant markets in OTC securities, derivatives and foreign exchange. The CFMA has proved to be extremely successful in that regard, because it clarified the exclusion from the Commodities Exchange Act (CEA) and the jurisdiction of the CFTC of OTC derivatives, swaps, and foreign

exchange transactions.[1] The much-needed legal certainty CFMA brought to these important sectors of the capital markets has improved efficiency in the market for U.S. Treasury securities in particular, which allows the government to borrow at a lower cost and save taxpayers money.

We commend Chairman Chambliss and this committee for reviewing the CFMA in the reauthorization process. In this testimony, the Association would like to share with you our view of markets for fixed-income and related products and the success of the CFMA, which we believe should be left intact. In particular, we would like to highlight the notion that since the enactment of the CFMA, the markets for "cash products" such as bonds and other securities have become even more interrelated with the markets for OTC derivatives such as interest rate and credit default swaps. Maintaining the swap exclusion contained in the CEA has never been more vital.

Cash and Derivatives: Convergence in the Fixed-Income Markets

Over the last decade, and particularly over the last five years, the financial markets have undergone a major transformation in the area of risk management. Products, technologies and strategies have been developed which allow market participants to parse different types of risk and price and manage them separately from each other. This in turn allows users—including, of course, banks and securities firms, but also including corporations in practically every industry—to determine the types and levels of risk they are able to accept, and to find willing counterparties to take on, at reasonable costs, risks they are not able to retain. Whether the risk faced by a firm involves interest rates, exchange rates, defaults on credit, energy prices, metals prices, weather or any of dozens of others, that risk can be managed much more cheaply and efficiently today than ever before. Improvements in risk management at the level of individual firms has led to an overall reduction in systemic risk in the broader economy. Federal Reserve Board Chairman Alan Greenspan made this observation in 2002, telling the Council on Foreign Relations that complex financial instruments developed to manage risk have made the global economy "a far more flexible, efficient and resilient financial system than existed just a quarter-century ago." Chairman Greenspan has reiterated this view on several subsequent occasions.

Perhaps the most important development in this area has been the rapid evolution of the market for OTC derivatives such as swaps, OTC options and forward agreements. Although markets for these products have existed for some time, the depth and liquidity of these markets in recent years have greatly enhanced the efficiency and reduced the cost of managing risk. A major factor contributing to this transformation of risk management is the regulatory structure for OTC derivatives set out in the CEA and clarified and enhanced in the CFMA. The CEA correctly recognizes these products as privately negotiated contracts between sophisticated commercial parties,

[1] In the case of foreign exchange, the exclusion applies when one of the parties to a contract is a regulated entity. See section 2(c) of the CEA.

not as publicly traded securities or futures. Unburdened by the constraints and costs of regulations that appropriately apply to the public securities and futures markets, the markets for OTC derivatives have been able to develop and flourish.

What all OTC derivatives have in common is flexibility. The fact that these contracts are negotiated between two counterparties means they can be tailored to specific needs, unlike a product such as a futures contract, the terms of which are established by the exchanges on which they trade. Although they typically are documented on industry-developed master agreements that help to standardize terms other than the basic economic terms of the contract, virtually all the terms of swap agreements are fully negotiable.

The importance of OTC derivatives is reflected in the growth in their use. Total notional[2] principal amount of interest rate and currency swaps outstanding has grown from around $11 trillion at the end of 1994 to over $161 trillion in the first half of 2004, according to the International Swaps and Derivatives Association (ISDA). In June 2003, there were $5.4 trillion in notional amount of credit default swaps, a product which did not exist at all ten years ago.

The evolution of the OTC derivatives market over the past decade has resulted in its integration with the market for "cash products," or traditional financial instruments such as bonds, loans and similar products. Bonds are debt securities issued by governments, corporations and others. Many OTC derivative products are instruments that represent the right to receive (or the obligation to make) payments calculated with respect to payments on an underlying debt security, loan, interest rate or exchange rate (sometimes referred to as the "reference asset"). OTC derivatives can be used either to hedge the risk from owning a position in the reference asset or to take a position that is the economic equivalent of owning the reference asset. Many counterparties are indifferent to whether they assume exposure to reference assets through the cash or derivatives markets.

The cash and derivatives markets have also converged because the dealers who make markets in these instruments are the same or related entities as those who often hedge their risks from dealing in different products on a global entity basis rather than on a product-by-product basis. The markets for bonds and similar products such as mortgage- and asset-backed securities, collateralized debt obligations (CDOs) and structured notes depend on dealers who act as market-makers[3] and trading counterparties. When an investor wants to buy or sell, say, a U.S. Treasury security, he or she typically trades with a bank or securities firm acting as a dealer. The same is true for OTC derivatives. When a finance or manufacturing company wants to hedge interest rate risk, for example, the counterparty to the transaction is virtually

[2] Notional value refers to the amount on which a contract is based, not the value at risk. In an interest rate swap for example, the notional amount refers to the amount on which a fixed or floating payment is calculated.
[3] A "market maker" in the OTC derivatives market is a firm that stands ready to act as a counterparty in OTC transactions.

always a bank or securities firm acting as a dealer. Because dealers serve as counterparties on a wide variety of cash and derivatives transactions, and because certain cash and derivative products tend to behave similarly under similar market conditions, dealers tend to manage their trading in these products on a consolidated basis.

The Commodity Futures Modernization Act

In 1974, when Congress amended the CEA to expand the list of commodities to which it applied, Congress recognized that it was inappropriate to apply the regulatory scheme of the CEA to certain financial products because they were not subject to the same regulatory needs as other products, or because they were adequately regulated by other regulators. For example, Congress excluded transactions in Treasury securities, foreign currency and other enumerated assets from the scope of the CEA. A regulatory exemption regarding swap transactions in the 1980s helped to further protect the burgeoning OTC derivative market, but a decade later it became clear Congress needed to act again to provide the type of legal certainty required for a vibrant OTC derivative market. During the congressional debate on the CFMA, the Association set out our three objectives for the legislation.

- Maintain the OTC markets as a viable alternative to traditional organized exchanges.
- Preserve the enforceability of contracts freely negotiated between market participants.
- Avoid duplicative and unnecessary regulation.

We commend Congress for addressing these concerns and adopting the changes to the CEA discussed below.

Excluded Commodities and Swaps

The CFMA provided legal certainty for OTC derivatives by adding a new section, section 2(d), to the CEA. That section makes clear that nothing in the CEA applies to agreements or transactions in certain "excluded commodities" as long as the agreements or transactions are entered into between persons that are "eligible contract participants" (a new term defined in the CFMA) and the contracts are not executed or traded on a trading facility (other than certain electronic trading facilities). The CFMA added a definition of "excluded commodities" that anticipates those financial measures upon which OTC derivatives are most likely to be based, including an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, any other macroeconomic index or measure, a differential, index or measure of economic or commercial risk,

return or value. With section 2(d), the CFMA removed any doubt surrounding the exclusion from the CEA for interest rate and credit derivatives between eligible contract participants.

The CFMA also includes a broader exclusion from the CEA for swaps than had been previously codified. Swaps between eligible contract participants that are subject to individual negotiations and are not executed on a trading facility do not fall under the CFTC's jurisdiction. This exclusion is vital to entities using swaps to hedge risk. With this exclusion, Congress recognized that the swaps market is both important to the broader financial markets and effectively regulated. Swap counterparties are typically financial institutions that are already subject to regulation.

Exempt Commodities

The term "exempt" commodity under the CFMA refers to a commodity that is not "excluded" from the CFMA but is also not an agricultural commodity. This is an important distinction that serves to exempt OTC derivatives in energy and metals from most of the provisions of the CEA other than the anti-fraud provisions. In the wake of the Enron bankruptcy, some members of Congress have advocated new regulation for OTC derivatives in energy and metals. The CFTC's swift and successful enforcement action against Enron for manipulation of the natural gas markets has netted $35 million in penalties to date and is a strong argument for leaving the current regulatory approach to OTC derivatives in energy and metals unchanged. The CFMA provided for the CFTC's anti-fraud authority over exempt markets, though some have questioned its applicability to bilateral and multilateral transactions. Clarification was sought in legislation last year and we look forward to working with the CFTC and Congress to resolve this question.

The Definition of Organized Exchange

Another important change under the CFMA was the clarification of the definition of "organized exchange" to essentially mean an entity that facilitates trading by or on behalf of a person that is not an eligible contract participant as defined under the CFMA. This clarification is important because it permits ongoing innovations in clearing systems and trading platforms for OTC derivatives without causing instruments traded on such facilities to become subject to the CEA. Under the revised Treasury amendment, transactions in the enumerated products are excluded from the CEA unless they are traded on an "organized exchange."

Ensure Contract Enforceability

Prior to the CFMA, market participants faced a good deal of legal uncertainty in the area of contract enforcement. Because of the lack of clarity regarding what was exempt from the CEA, counterparties could take the position that a contract was

undertaken illegally off an exchange and therefore unenforceable. While such actions were largely without merit, the need to litigate through an uncertain legal environment inhibited the development and innovation of the OTC derivative market in the United States. The clarification on enforceability found in section 22 of the CFMA is an example of another wise policy decision by Congress.

Conclusions

The CFMA strikes a delicate balance between regulating a rapidly changing market and encouraging innovation and diversity. Prior to the CFMA, the OTC derivative market was restrained by legal uncertainty. Thanks to the foresight of Congress and other policymakers, that market is now thriving and helping to save taxpayers money by lowering the cost of borrowing for the federal government. Improved risk management and lower capital costs also help stimulate the broader economy. In the context of the reauthorization process, the Association strongly urges this subcommittee and Congress not to alter any of the fundamental elements of the CFMA that encourage an orderly and innovative OTC derivative market.

DOCUMENTS SUBMITTED FOR THE RECORD

MARCH 10, 2005

Statement of Senator Thad Cochran

Commodity Futures Trading Commission Hearing

March 10, 2005

Mr. Chairman thank you for holding these hearings regarding the reauthorization of the Commodity Futures Trading Commission. I also want to thank the panelists that will provide their important testimony today.

The reauthorization of the Commodity Futures Trading Commission provides this Committee with the opportunity to review the current regulations and policies of the Commission. Through passage of the Commodity Futures Modernization Act of 2000 (CFMA), Congress made many fundamental changes in the role that government should have in regulating the futures industry, especially in the area of derivative trading.

Since the passage of this act, we have seen tremendous growth in the futures industry. The CFMA provides the opportunity for new market entrants, making the futures industry

more competitive and efficient. Since passage of the CFMA, trading volume of futures has increased dramatically among all contracts, especially in the area of trading interest rate and currency on over-the-counter contracts.

In my meetings with industry officials leading up to these hearings, the over-all opinion of the CFTC's performance has been positive. Mr. Chairman, I believe that the regulatory framework of the Commodity Futures Modernization Act has played a vital role in the growth of the futures and options markets and I look forward to working with my colleagues to ensure its continued effectiveness. I look forward to the testimony of the panelists.

Statement of
The National Grain Trade Council
On Reauthorization of the Commodity Futures Trading Commission

For the Agriculture, Nutrition, and Forestry Committee
U.S. Senate

March 10, 2005

Mr. Chairman and Members of the Committee:

The Council is a North American trade association that brings together grain exchanges, boards of trade, and national grain marketing organizations with their grain industry counterparts including grain companies, millers and processors, railroads, futures commission merchants, and banks. The Council's mix of membership provides it with a unique perspective on futures trading issues, such as reauthorization of the Commodity Futures Trading Commission. We have shared our expertise in this arena with you on numerous occasions in the past and we welcome the opportunity to do so again today.

As an overview of our statement, the National Grain Trade Council supports the movement from prescriptive regulation to the core principles of the Commodity Futures Modernization Act of 2000 (CFMA). The Council and its members are very pleased with how the CFMA has been implemented and the industry has prospered under it. Since 2000, the futures industry has experienced strong growth in volume and in the types of products available. The CFMA ushered in an environment that allows for advances in technology, such as electronic trading, that would not have occurred as efficiently or as rapidly under more restrictive regulation and oversight. In general, the Council views the CFMA as very effective at achieving its goals.

The Council strongly believes that price discovery, the fundamental goal of a regulatory structure, is best accomplished by vesting responsibility with exchanges and providing the Commodity Futures Trading Commission (CFTC) with the necessary tools for oversight authority and meaningful regulation. In the spirit of the CFMA, we advocate leveling the playing field between agricultural commodities and other physical commodities. The Council believes that enumerating agricultural commodities no longer advances the public policy goals originally envisioned.

When discussing meaningful regulation, we make several recommendations regarding approval for increases of speculative position limits, the agricultural trade options program, and the application process for new contract markets. Finally, the Council would like to draw your attention to the negative impact Financial Accounting Statement 133 is having on commodity markets.

Equitable Treatment for Agricultural Commodities

The Council believes that enumerating agricultural commodities under the CFMA no longer serves to advance public policy. Agricultural markets have matured, especially under the

CFMA, and the more prescriptive regulation is no longer necessary to protect the markets or the market participants. Modern US agricultural futures and options markets are much deeper, draw significant representation from worldwide commercial hedging interests, and offer greater trading opportunities for a speculative community whose participation is as essential for the success of our markets as farmer and commercial hedging communities. Trading volume is high and growing each year – testimony to the solid connection between US exchange prices and the underlying prices of domestic and internationally traded physical commodities. As the CFTC moves toward becoming more of an oversight authority under the CFMA, Congress may want to consider whether the regulatory structure should recognize the maturity of the agricultural markets and put them on parity with the other physical commodity markets.

Speculative Position Limits

The Council supports the petitions of the Chicago Board of Trade, the Kansas City Board of Trade, and the Minneapolis Grain Exchange for repeal or amendment of speculative position limits. The Council strongly believes that exchanges should be responsible for setting speculative position limits, subject to the Commission's oversight; however, if federal speculative position limits are retained, the Council supports increasing the limits and the maintenance of parity across wheat exchanges.

By eliminating federal speculative position limits, the Council believes two goals would be accomplished: 1) reduction in duplicative regulatory oversight and 2) greater market transparency. Core Principle 5(d) of the CFMA requires boards of trade to adopt position limits where necessary and appropriate, subject to the oversight of the CFTC; however, a small subset of agricultural commodities continue to be subject to the jurisdiction of the CFTC.

Currently, exchanges must go through the self-regulatory process to change their rules to allow for an increase in limits. Then, they must petition the CFTC to modify its rules to permit such an increase. This duplicative regulatory structure is different from other contracts and different even from other agricultural contracts. Elimination of the regulatory redundancy would fully implement the core principals of the CFMA for all agricultural commodities and allow exchanges to respond quickly to the ever-changing market conditions, while retaining CFTC oversight. The CFMA pushes the regulatory structure to permit greater self-regulation of the markets. Allowing exchanges to set speculative position limits, subject to the guidelines and oversight of the CFTC, is part of achieving that goal.

Furthermore, allowing exchanges to increase speculative position limits would also increase activity in a transparent marketplace and allow exchanges to compete more efficiently with over-the-counter markets. If a transaction exceeds the current limits, the transaction moves off-exchange, to a less transparent market. The Council strongly believes that streamlining the process helps all market participants at all levels by increasing activity in a transparent marketplace and increasing liquidity.

We would also like to bring to your attention our concern that funds are taking a position in agricultural indexes of sufficient size to justify petitioning the CFTC for a hedge exemption. In our view, this has the potential to present a misleading perception of commercial participation

versus speculative participation in agriculture markets. As this issue moves forward, we believe the definition of a commercial participant should be carefully assessed.

Agricultural Trade Options

Another issue that warrants further review by the CFTC is the agricultural trade options (ATO) pilot program. The Council supports the comments of Acting Chairman Brown-Hruska[1] on the need to make viable risk-management tools, like ATOs, available for producers.

Under the ATO pilot program, only one entity has registered as an ATO merchant, and according to Commission records, this merchant enters into a small number of options each year. The program has not met the expectations of producers, industry or the CFTC. We commend Acting Chairman Brown-Hruska for being open to revitalizing the program. Over the years, the Council has watched the CFTC and industry wrestle with ideas on how to make the ATO program more productive, but at this point, the Council does not believe that the existing framework is workable.

Instead, the Council believes that now is the time to consider a fresh start. Over the last four years, the industry has seen remarkable innovation in the energy and metals markets. Products continue to improve and the industry continues to develop better tools for managing risk. The Council suggests tapping into that innovation and putting it to work to deliver a risk management tool for producers that is both valuable and effective. In our view, before such tools can be developed, the CFTC and the industry must begin by defining the pool of potential market participants, including examining who should be a commercial participant and what is the appropriate level of creditworthiness.

The Council, working in concert with you, the CFTC, industry and other affected parties is eager to develop such a program.

Application Transparency

The Council champions market competitiveness but believes that transparency is an essential element when introducing new exchanges to the market. We, like the CFTC, believe that it is imperative that the regulatory framework seeks to prevent market manipulation, protect customers, provide financial integrity and promote market transparency. To ensure this is

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[1] Sharon Brown-Hruska, "The Future of Futures" (February 3, 2005) *available at* http://www.cftc.gov; "National Grain and Feed Association Seminar on Trading, Trade Rules, and Dispute Resolution" (May 4, 2004) *available at* http://www.cftc.gov. "While the utility of [agricultural trade options] is clear, we have a regulatory program that is perceived by practically all elevator operators and other potential agricultural trade option merchants to be too burdensome to be worth the effort to offer the instruments. . . [E]ven as agriculture, and the grain trade specifically, have to contend with increased global competition, and with price volatility and the uncertainty that comes with it, some of the more useful innovations, risk management products, and technologies that have been developed and are widely in use in other industry sectors have not been offered and remain unavailable to the agricultural community. . . Since becoming a Commissioner at the CFTC, what has concerned me more than anything is the lack of availability of such products in the OTC markets that would work for the agriculture industry."

accomplished, we believe the application review process for a new exchange must be informed, deliberative, complete and accurate.

The CFMA lowered many regulatory hurdles, making it easier for new entrants to participate in the marketplace. Over the last four years, the market and the CFTC have had an opportunity to adjust to the regime change. Now is the time to draw from our experiences and examine the application process for new exchanges to ensure that there is enough opportunity for discussion and debate. Business plans and marketing today are dramatically different than when many of our existing exchanges originally registered. The Council believes that the application process should ensure that the CFTC, the marketplace and the public receive full and consistent information about new applicants.

FAS 133

Though we understand that financial accounting statements are outside the jurisdiction of the CFTC, the Council believes that it is important to bring to your attention the negative impact Financial Accounting Statement 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities, is having on the commodity markets. Under FAS 133, financial firms are allowed to hedge various components that determine a financial asset's price. Allowing agricultural commodity hedgers to hedge components of a finished product would promote greater market participation and more accurate reporting of financial condition.

FAS 133 requires a grain or food processor to report, under certain market conditions, the interim gains or losses from the futures hedge, but it may not report the offsetting losses or gains from the change in price of the physical commodity - as though the movement in the price of the hedge instrument has no relation to the movement of the price of the physical commodity that was hedged[2]. This occurs primarily because FAS 133 prohibits grain processors from hedging components of non-financial assets. Grain processors often hedge one or more ingredients of a finished product that they purchase and use in their manufacturing process, not the finished product itself. This is done because there may not be a viable way to hedge every ingredient of the finished product or prices of certain components of the finished product may be set by an agreement with the supplier. By comparison, financial firms are allowed to designate whether they are hedging the interest rate risk component or credit risk component of a financial asset or liability.

Decades of experience have shown that the Financial Accounting Standard Board's (FASB) assumption that the price of the hedge instrument has no relation to the movement of the price of the physical commodity is incorrect. Properly constructed hedges significantly reduce risk for a processor or other user of grain. The demand for such hedges underlies the health of the entire US grain marketing system, from country elevators publishing daily bids to farmers for cash delivery of grain for daily, weekly and monthly calendar positions in some cases more than a

[2] For example, a grain processor might in January enter into a cash transaction calling for physical delivery to occur in June, employing an offsetting futures market hedge transaction in a July futures contract. Under FAS 133, the processor must report the interim gains or losses from the futures hedge, but may not report the offsetting losses or gains from the change in price of the physical commodity - as though the movement in the price of the hedge instrument (in this case, July futures) has no relation to the movement of the price of the physical commodity that was hedged.

year in the future, to grain processors and livestock producers who depend on the ability to price commodity inputs accurately in spot and forward markets. Any accounting standard that interrupts this tested system diminishes marketing opportunities for farmers, increases risk for grain handlers and consumers across the marketing spectrum, and reduces participation and liquidity in futures and options markets, to the detriment of all participants.

The negative effects of FAS 133 on the futures market are real. Grain and food processors must either misrepresent their financial state to comply with FAS 133 or opt to not participate in the market. Many firms without the internal expertise or staff necessary to deal with the onerous rules have simply opted to avoid hedging, thus increasing their risks and limiting business for the hedging community. Either result, misrepresentation of financial condition or inhibiting market participation, is an undesirable outcome.

The Council, in conjunction with other industry groups, has petitioned the FASB to make changes but, so far, our efforts have been unsuccessful. To rectify this problem, we have asked FASB to grant agricultural commodity hedgers the same ability granted to financial hedgers. The Council would welcome the opportunity to discuss this issue with you in greater detail.

Conclusion

In conclusion, the Council supports the advances made under the CFMA. We are very pleased with the direction in which we are headed and look forward to working with you on solutions that continue to push the industry toward ever more efficient and meaningful regulation.

Statement of Martin Doyle, President, OneChicago LLC Hearing on CFTC Reauthorization, March 10, 2005 Before the Senate Committee on Agriculture, Nutrition, and Forestry

Mr. Chairman and members of the Committee, I am Martin Doyle, President of OneChicago, LLC, the U.S. exchange for single stock futures and other security futures products. On behalf of OneChicago, our Chairman Peter F. Borish, and our joint-venture owners, we greatly appreciate the opportunity to submit our statement for the hearing record.

What is OneChicago?

OneChicago is a true product of the Commodity Futures Modernization Act of 2000. A main purpose of the CFMA was to "provide a statutory and regulatory framework for allowing the trading of futures on securities" by ending the almost 20 year statutory ban on U.S. trading in those instruments. It is no exaggeration to say that without this Committee's work on the CFMA, OneChicago would not be here. We thank you and your predecessors for your work on that ground-breaking legislation.

By law, security futures are futures contracts on an individual security or a narrow-based securities index. Congress understood that these new forms of futures contracts could be attractive to mutual funds, hedge funds, pension funds, financial institutions and other investors who are either trying to manage their investment risk or assume a market view. Offering these products in an exchange-trading environment was thought to promote price transparency and liquidity in these products within a safe and financially-secure clearing system.

OneChicago is a joint venture of the Chicago Board Options Exchange Incorporated® (CBOE®), Chicago Mercantile Exchange Inc. (CME) and the Chicago Board of Trade (CBOT®). OneChicago trades only single stock futures and other security futures products. All OneChicago products are electronically traded on the CBOEdirect® match engine and accessible through the CBOEdirect and GLOBEX® platforms. All security futures can be traded through either a securities or a futures account.

OneChicago is a contract market designated by the Commodity Futures Trading Commission and is a notice registered securities exchange with the Securities and Exchange Commission. OneChicago is the only U.S. market in single stock futures and security futures products. And OneChicago offers a market only in those new investment products.

OneChicago's Start and Challenges.

OneChicago began trading on November 8, 2002, with 34 listings or futures on 34 stocks. Today, OneChicago lists 136 single stock futures contracts. All of the underlying stocks are included in the S&P 500, ranging from Apple and Boeing to Starbucks and Wal-Mart. We

also offer futures contracts on seven narrow-based stock indexes[1] and one exchange traded fund (ETF) known as DIAMONDS.

Our progress has been steady. As with any new trading product, it has been a challenge to develop market momentum and liquidity. In 2003, our first full year, OneChicago traded 1,619,194 security futures contracts, which equates to an average daily volume (ADV) of 6,425 contracts. Our 2004 volume increased to 1,922,726 contracts for an ADV of 7,630.[2] While this does represent a 19% increase, our volumes and percentage gains pale when compared to those at overseas security futures exchanges. This situation is distressing to us, as we believe it will be to the members of this Committee, especially since we know that one of the principal reasons Congress chartered single stock futures in the CFMA was to make sure U.S. markets could meet our foreign competition.

When Congress lifted the ban and authorized security futures products in 2000, security futures already had begun to be traded in foreign markets. We know Congress did not want to see U.S. markets fall behind those in England, Italy, Spain or India, among others. The U.S. is the home of financial innovation, the birthplace of financial futures trading. Having to play catch-up with foreign markets was not a desirable option for any one. Congress ended the ban and allowed us to offer security futures products in an effort to avoid having the U.S. markets trail those in other countries.

But look at the numbers from our foreign competition. Even accounting for their head start, their volume and growth are out-pacing us. Consider the following chart.

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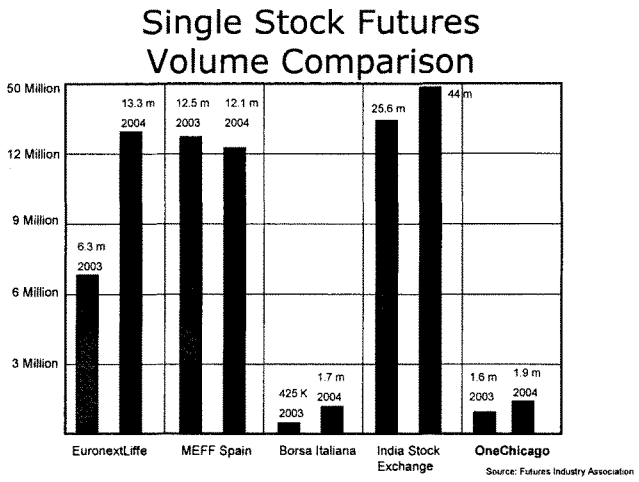
[1] We list futures on the Dow Jones MicroSector Indexes, which are narrow-based indexes of five highly correlated stocks within the same industry sector. OneChicago has made a strategic decision to delist these narrow based indexes following the March expiration to concentrate on single stock futures.

[2] Our open interest at OneChicago has consistently held between 150,000 and 300,000 contracts, depending upon where we are in the contract expiration cycle. As of Monday, March 7, 2005, we had 203,536 contracts in open interest, demonstrating to us that the product is indeed viable and that the financial community is interested in trading single stock futures. We have attached to this testimony a list of all of the contracts trading on OneChicago and our trading volume for the month of February, 2005.



As the chart shows, at the London based Euronext.Liffe exchange, 2004 single stock futures volume was up 114% over 2003 volume, with a total to 13.5 million contracts traded. And at Italy's Borsa Italiana, single stock futures volume rose more than 250% last year as it traded over 1.7 million contracts. At the Stock Exchange of India, 2004 single stock futures volume was up 72% to 44 million contracts, according to figures compiled by the Futures Industry Association. And finally, even at Spain's MEFF exchange, where single stock futures volume was basically flat, they were still able to trade 12.1 million contracts. As you can see, it is clear that at this time the security futures industry in the United States has not caught up with our competitors on foreign exchanges.

There are many potential explanations for these comparative volume and growth rates. But the fact remains that one area of difficulty that has compromised our ability to grow this market stems from certain aspects of the CFMA itself, and its implementation.

For that reason, our message to this Committee is simple: "we need some help." We are starting a new business and offering a new product under special regulatory restrictions imposed by both the Commodity Futures Trading Commission and Securities and Exchange Commission. We have made a solid start. Like any new venture, there are things we have done well and things we could have done better. We have control over those business and operational issues. But we need your help with some of the regulatory and statutory hurdles.

We understand the reasons we are operating under some of these special constraints -- any new product involves many "unknowns" and is often greeted with regulatory caution and a list of well-intentioned "what ifs." OneChicago has no quarrel with the bulk of the regulatory framework or the good faith efforts of the CFTC and the SEC. While in a perfect world we would prefer a single regulator, we try to be realists. In a number of critical areas,

however, based on our now two-year experience with this new product, we believe the regulations and laws governing U.S. security futures markets could use some adjustment so that we may compete more effectively with foreign markets.

Some will counsel patience and state correctly that gaining market acceptance for any new product is a substantial challenge. In our case, that challenge has been magnified by the following phenomenon: before OneChicago's creation, U.S. financial market participants were using other available products to perform many of the same economic functions that security futures perform. Through these other products -- whether synthetic futures formed through combination of exchange-listed stock options, over- the-counter options or equity swaps and other forms of derivatives -- U.S. investors were finding ways to hedge stock price risks under existing regulatory rules. To attract those investors to our market, therefore, OneChicago had to convince our potential customers that there were advantages to shifting their business practices to trading a new product on a new exchange.

But OneChicago's new product also came with new regulatory strings attached. The CFMA treated single stock futures and security futures as a hybrid, part security, part option, part futures contract. Trading OneChicago's new products therefore required market participants to become comfortable and compliant with new regulatory rules and other legal requirements. Although many people worked very hard to try to smooth over the rough edges of this hybrid status, the fact remains that offering and trading OneChicago's products required market participants to adjust to a whole new set of legal rules of the road. This has inhibited our growth and development, as it would any new innovative product. Based on our experience to date, we would like the Committee's assistance in removing some of these obstacles to achieving market acceptance of security futures.

OneChicago's Recommendations.

Some of these obstacles would not involve statutory changes, and some would. In the non-statutory category, our concerns relate to two margin issues and one registration issue. In terms of margin, we have requested that the SEC and CFTC allow a regime of portfolio margining to apply to security futures. Portfolio margin assesses financial risk based on each market participant's portfolio of futures and options contracts, rather than on an individual contract or product basis. It takes into account the extent to which related contracts in different markets, for example, Treasury Notes and Eurodollars, or corn and soybeans, have price movements in common. It allows for more efficient use of margin capital without sacrificing financial integrity. Actually, we believe it enhances financial integrity. The futures markets have utilized portfolio margin for many years. The SEC and CFTC indicated when OneChicago began operations that they would agree soon to a portfolio margin regime for security futures. More than two years later, we are still waiting. We would ask the Committee to support the inclusion of report language in connection with the CFTC Reauthorization bill to encourage the agencies to finalize this important initiative.

One source of liquidity for any market is its market-makers. Encouraging market making activity is therefore an important element in creating the critical mass of liquidity that is essential to narrowing bid-ask spreads that will be attractive to customers and to providing sufficient market depth so that investors who establish positions will know they can exit the

market efficiently and at a fair price. Market-makers also are not interested in maintaining positions with market exposure for extended periods of time, let alone overnight. For these reasons, market-makers typically enjoy special, lower margin requirements than other traders. OneChicago negotiated special market-maker margin rules with the SEC and CFTC. Unfortunately, those rules have proven to be more complicated and impractical to apply than anyone contemplated. We would like to see those rules streamlined and relaxed. OneChicago will be entering into discussions with the SEC and CFTC to achieve that purpose and to amend those rules. We would greatly appreciate having the Committee's report indicate its support for that endeavor.

Finally, an issue has arisen whereby CFTC-registered commodity trading advisors have been discouraged from directing trading toward the security futures markets because they fear they will be required to register as investment advisers with the SEC if they do. This legal uncertainty has had a chilling effect on participation by many financial institutions and other pools of investment capital. Again, we would appreciate this Committee's assistance in obtaining a from the SEC and CFTC clear, bright-line test that allows CTA's to participate in security futures without fear of triggering SEC investment adviser registration.

In terms of statutory changes, we would recommend three changes. First, the level of initial and maintenance margin for security futures has been the subject of discussion from the very beginning. After much negotiation, the CFMA linked security futures margins to stock options margins, essentially at 20% of notional value. That level has proven, quite simply, to be unnecessarily high and has imposed an unwarranted cost that has discouraged new customers from using our products. While the agencies could allow for a reduction of the levels of margin without a statutory change, in light of the perceived sensitivity of this issue we would recommend that Congress amend the statute specifically to ensure margin levels at 15% of notional value. That level in almost all instances would satisfy the systemic risk and financial integrity concerns that generally animate margin-setting without imposing too high a barrier to entry of new positions.

Suitability is the next area. Generally, the futures industry operates under a "know your customer" rule and not a "suitability" rule as is applicable to securities markets. The CFMA requires futures commission merchants and other futures professionals to satisfy the same suitability requirements as they would have under the securities laws. As a substantive matter of customer protection, we do not believe there is a material difference in these two approaches. But fear of the unknown application of securities suitability standards has caused many futures firms to be unwilling to recommend or broker security futures trades. Since the real purpose of the CFMA's provision was to make sure customers are adequately protected and NFA's "know your customer" rule serves in every material respect the same customer protection purposes as a suitability rule, we would urge Congress to change the statute to allow futures professionals to meet either a "know your customer" or a "suitability" rule imposed by an SRO in dealing in securities futures.

Taxation is the last area. As this Committee well knows, the special nature of futures trading has for many years justified a regime of 60-40 treatment for futures. During the CFMA, one issue Congress considered was the proper tax treatment of gains and losses from trading and market making in security futures contracts, including the extent to which 60/40

treatment should be accorded to dealers in these new products. Congress decided that dealers in security futures should receive 60-40 treatment. The definition of dealer in that context was left to the Secretary of the Treasury. Congress stated that the definition of security futures dealer should be made consistent with the generally recognized purpose of providing:

> "comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers."

H.R. Conf. Rep. No. 106-1033, 106th Cong., 2d Sess. 1036 (2000) (emphasis added).

Despite this guidance and despite the good faith efforts of all interested parties, the ultimate determination of dealer status for tax purposes was made in a way that is unduly complicated and gives securities futures less favorable treatment than is afforded to securities options. To remedy this disparity, OneChicago would recommend a bright-line test that allows all members of an exchange trading security futures to qualify for 60-40 tax treatment for their securities futures trading activity. In addition to achieving practical comparability with securities options, this approach would allow members of futures exchanges to experience the same tax treatment for security futures as they have for other futures trading activity.

Conclusion.

OneChicago thanks the Committee for its interest in, and attention to, the development of a successful U.S. security futures market. We would greatly appreciate your consideration of our modest list of reforms to the regulation of our market which we believe will strongly serve the public interest and the national interest.

OneChicago

February 2005 Volume Report

Product	Average Daily Volume	Monthly Volume	Previous Year Monthly Volume	% Change	Year to Date Cumulative Volume	Month End Open Interest
Exchange Total	2,993	56,858	51,821	10%	242,586	178,576
ETF Futures	31	584	1,572	-63%	2,330	2,777
Single Stock Futures	2,960	56,232	49,952	13%	240,042	175,584
MicroSector Futures	2	42	297	-86%	214	215
ETF Futures						
DIAMONDS® (DIA1C)	31	584	1,572	-63%	2,330	2,777
Single Stock Futures						
Alcoa Inc. (AA1C)	4	76	643	(1)	1,781	1,537
Apple Computer Inc. (AAPL1C)	91	1,723		n/a	2,805	729
American International Group (AIG1C)	9	179	24	646%	249	234
Allstate Corp. (ALL1C)	2	33		n/a	2,330	2,392
Altera Corp. (ALTR1C)	37	702	414	70%	1,212	69
Applied Materials (AMAT1C)	21	406	826	-51%	691	51
Advanced Micro Devices Inc. (AMD1C)	17	331		n/a	15,891	11,212
Amgen Inc. (AMGN1C)	130	2,466	999	147%	9,376	1,585
Amazon.com Inc. (AMZN1C)	37	707	887	-20%	1,668	179
American Express (AXP1C)	8	153	106	44%	2,721	5,836
Boeing Co. (BA1C)	5	92	48	92%	216	65
Bank Of America Corp (BAC1C)	1	22	123	-82%	10,134	5,518
Bed Bath & Beyond (BBBY1C)	22	410	48	754%	914	85
Best Buy Company Inc. (BBY1C)	8	157	35	349%	277	6
Biogen Idec Inc. (BIIB1C)	24	460	546	-16%	904	85
Bristol-Myers Squibb Co. (BMY1C)	1	14	557	-97%	91	25
Brocade Communications Sys. (BRCD1C	12	235	344	-32%	834	140
Broadcom Corp-Cl A (BRCM1C)	41	774	838	-8%	1,850	246
Boston Scientific Corp. (BSX1C)	8	149		n/a	299	61
Citigroup Inc. (C1C)	3	66	53	25%	109	165
Computer Associates Int'l Inc. (CA1C)	20	389		n/a	489	25
Caterpillar (CAT1C)	22	414	141	194%	1,060	343
Cephalon Inc. (CEPH1C)	1	19	73	-74%	79	13
Check Point Software Tech (CHKP1C)	20	382	1,573	-76%	814	44
Comcast Corp. (CMCS1C)	6	122	41	198%	192	30
Chicago Mercantile Holdings Inc. (CME1C	1	27		n/a	67	18
Comverse Technology Inc. (CMVT1C)	6	115	146	-21%	229	63
Cisco Systems Inc. (CSCO1C)	41	781	990	-21%	1,597	457
ChevronTexaco Corp. (CVX1C)	4	78	101	-23%	458	27
Dupont (E.I. Du Pont de Nemours Co.)	3	59	52	13%	78	33
Dell Computer Corp. (DELL1C)	45	858	491	75%	5,536	7,723
Walt Disney Co. (DIS1C)	3	53	2,412	-98%	57	47
DOW Chemical Co. (DOW1C)	1	10	237	-96%	31	9
eBay Inc. (EBAY1C)	173	3,295	1,297	154%	8,852	783
Electronic Data Systems Corp. (EDS1C)	2	41		n/a	93	44
Eastman Kodak (EK1C)	3	57	46	24%	2,974	6,916
Elan Corp. PLC (ELN1C)	13	254		n/a	361	155
Emulex Corp. (ELX1C)	2	40	3,209	-99%	106	4
EMC Corp. (EMC1C)	3	51		n/a	235	8
Ford Motor Co. (F1C)	1	28	83	-66%	62	51
Federated Department Stores (FD1C)	8	149		n/a	389	21
General Electric Co. (GE1C)	68	1,283	407	215%	7,473	2,080
Genzyme Corp - Genl Division (GENZ1C	27	504	294	71%	1,098	81
General Motors Corp. (GM1C)	8	150	19	689%	6,078	1,567
Google Inc. (GOOG1C)	94	1,781		n/a	4,474	2,057
Goldman Sachs Group Inc. (GS1C)	20	379	470	-19%	613	159
Halliburton Co. (HAL1C)	66	1,262	60	2003%	7,254	6,220
Home Depot Inc. (HD1C)	-	2	12	-83%	88	3
Honeywell International Inc. (HON1C)	12	222	540	-59%	241	3,847
Hewlett-Packard Co. (HPQ1C)	4	70	616	-89%	278	90
International Business Machines (IBM1C	7	134	394	-66%	4,686	2,313

Intel Corp. (INTC1C)	20	384	4,562	-92%	1,090	2,379
International Paper Co. (IP1C)	2	30	59	-49%	61	14
Jet Blue Airways Inc. (JBLU1C)	-	2		n/a	640	21
Johnson & Johnson (JNJ1C)	161	3,063	57	5274%	7,842	7,551
Juniper Networks (JNPR1C)	15	286		n/a	735	149
J.P. Morgan Chase Co. (JPM1C)	1	26	40	-35%	6,980	3,444
KLA-Tencor Corp. (KLAC1C)	51	963	855	13%	1,901	34
Coca-Cola Co. (KO1C)	4	83	105	-21%	5,216	6,209
Kohl's Corp. (KSS1C)	4	73		n/a	189	-
Lennar Corp. (LEN1C)	27	511		n/a	1,047	218
Linear Technology Corp. (LLTC1C)	21	390	358	9%	1,701	114
Eli Lilly and Co. (LLY1C)	7	124		n/a	2,489	4,144
Limited Brands Inc. (LTD1C)	-	-		n/a	-	40
McDonald's Corp. (MCD1C)	9	171	6,394	-97%	4,177	10,716
Merrill Lynch Co. Inc. (MER1C)	2	32	152	-79%	44	47
3M Co. (MMM1C)	13	241	218	11%	593	150
Altria Corp. (MO1C)	1	22	62	-65%	2,118	2,019
Motorola Inc. (MOT1C)	5	88	335	(1)	417	67
Motorola Inc. (MOT2C)	-	2		n/a	7	1,040
Merck Co. Inc. (MRK1C, MRK2C)	5	91	29	214%	182	2,488
Microsoft Corp. (MSFT1C)	5	88	391	-77%	296	8,941
Micron Technology Inc. (MU1C)	1	25	1,186	-98%	317	160
Morgan Stanley (MWD1C)	2	40	121	-67%	119	16
Maxim Integrated Products Inc. (MXIM1	25	480	1,248	-62%	1,039	178
Newmont Mining Corp Hldg Co. (NEM1C	38	724	227	219%	1,079	112
Northrop Grumman Corp. (NOC1C)	161	3,050	59	5069%	3,057	3,099
Nokia Corp. ADR (NOK1C)	13	242	759	-68%	566	147
Nvidia Corp. (NVDA1C)	51	970	196	395%	1,636	214
Novellus Systems Inc. (NVLS1C)	30	570	589	-3%	1,009	100
Nextel Communications Inc. (NXTL1C)	325	6,183	716	764%	12,371	6,187
Oracle Corp. (ORCL1C)	15	286	364	-21%	865	208
Phelps Dodge Corp. (PE1C)	25	483		n/a	1,187	23
PepsiCo Inc. (PEP1C)	2	31	84	-63%	47	18
Pfizer (PFE1C)	108	2,047	81	2427%	4,996	5,085
Procter & Gamble Co. (PG1C)	4	70	421	-83%	459	57
PMC Sierra Inc. (PMCS1C)	29	543		n/a	1,370	335
QUALCOMM Inc. (QCOM1C)	23	440	1,816	-76%	1,302	345
QLogic Corp. (QLGC1C)	30	577	392	47%	1,150	104
Reynolds American Inc. (RA1C)	46	876		n/a	877	1,100
Research in Motion Ltd. (RIMM1C)	81	1,535		n/a	1,921	182
SBC Communications Inc. (SBC1C)	1	22	15	47%	18,382	5,006
Starbucks Corp. (SBUX1C)	39	745	1,323	-44%	1,422	218
Siebel Systems Inc. (SEBL1C)	2	35	93	-62%	467	105
Schering-Plough Corp. (SGP1C)	4	71		n/a	2,283	10,021
Sirius Satellite Radio Inc.	14	263		n/a	956	222
Schlumberger Ltd. (SLB1C)	39	750	125	500%	3,172	3,525
SanDisk Corp. (SNDK1C)	77	1,465	817	79%	2,220	146
Sun Microsystems (SUNW1C)	18	349	844	-59%	980	426
Symantec Corp. (SYMC1C)	10	191	545	-65%	1,001	151
AT&T Corp. (T1C)	4	81	59	37%	133	74
Target Corp. (TGT1C)	24	447		n/a	701	90
Tenet Healthcare (THC1C)	-	2		n/a	82	-
TIBCO Software Inc. (TIBX1C)	12	219	810	-73%	377	119
Time Warner Inc. (TWX1C)	6	113	59	92%	145	34
Texas Instruments Inc. (TXN1C)	10	184	340	-46%	327	79
Tyco International Ltd. (TYC1C)	5	96	434	-78%	117	56
United Parcel Service Inc. (UPS1C)	-	-		n/a	6	4
U.S. Bancorp (USB1C)	24	459		n/a	716	459
United Technologies Corp. (UTX1C)	6	107	407	-74%	119	38
Viacom Inc. (VIAB1C)	-	7		n/a	4,304	4,296
VERITAS Software Corp. (VRTS1C)	4	69	308	-78%	320	25
Verizon Communications Inc. (VZ1C)	4	76	50	52%	10,758	5,001
Wells Fargo & Co. (WFC1C)	41	774	118	556%	3,717	6,627
Williams Companies Inc. (WMB1C)	1	25		n/a	40	1
Wal-Mart Stores Inc. (WMT1C)	14	270	77	251%	362	3,853
Xilinx Inc. (XLNX1C)	11	208	541	-62%	557	122
Exxon Mobil Corp. (XOM1C)	6	116	81	43%	260	1,631
Yahoo! Inc. (YHOO1C)	57	1,082	475	128%	2,632	349

Futures on Dow Jones MicroSector Indexes℠						
Aerospace (XARO9C)	-	-	-	n/a	8	8
Biotechnology (XBTC9C)	-	-	24	-100%	-	25
Communications Technology (XCMT9C)	-	-	-	n/a	39	31
Industrial, Diversified (XIDD9C)	-	8	31	-74%	18	45
Investment Services (XSCR9C)	1	14	72	-81%	36	4
Pharmaceuticals (XDRG9C)	1	20	10	100%	113	101
Precious Metals (XPCS9C)	-	-	5	-100%	-	1

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Submitted Statement

of the

National Grain and Feed Association

to the

Committee on Agriculture, Nutrition and Forestry

U.S. Senate

March 10, 2005

This statement is submitted to the Senate Committee on Agriculture, Nutrition and Forestry in conjunction with the March 10, 2005 hearing on reauthorization of the Commodity Futures Trading Commission. We appreciate the opportunity to present our views on the reauthorization of the CFTC and related risk management issues confronting agriculture.

The National Grain and Feed Association is a U.S.-based non-profit trade association of more than 900 grain, feed and processing firms comprising over 5,000 facilities that handle more than two-thirds of all U.S. grains and oilseeds. Founded in 1896, the NGFA encompasses all sectors of the industry, including country, terminal and export elevators, feed mills, cash grain and feed merchants, livestock integrators, grain and oilseed processors and futures commission merchants.

Our industry, as the first purchaser of grains and oilseeds from producers, has traditionally provided both marketing and risk management services to farmers through a variety of cash contracts. NGFA's membership also represents a substantial portion of the hedge business volume on the grain exchanges, so we have strong interest in the performance of both futures and cash markets. In our statement we will address three

broad issues: 1) Futures exchange performance and oversight by the CFTC; 2) Greater legal clarity for cash grain contracts; and 3) Producer risk management in an era with potentially lower government support for production agriculture.

Futures Exchange Performance and Oversight by the CFTC

The NGFA strongly supports reauthorization of the CFTC. The agency performs an important oversight and regulatory role that benefits the grain, feed and processing industry as a primary user of agricultural products on regulated exchanges. Our organization maintains a strong, professional working relationship with the CFTC, and we have been generally pleased in recent years with the leadership and direction taken by agency leadership.

U.S. futures exchanges are experiencing higher volumes of trading in both agricultural and other commodities. In accommodating this growth, the order entry and execution systems of the exchanges have at times been challenged during high volume, rapidly moving markets. On April 15, 2004, at the Chicago Board of Trade, NGFA members reported excessive delays in some orders being entered, order execution and in reporting fills of orders as well as some wide bid/offer spreads. Most of the problems seemed to be occurring with smaller-sized orders.

The NGFA contacted the CBOT, urging that the exchange give the execution and performance issues a high priority. Within two days, NGFA received a response from the CBOT president that outlined a number of specific measures the exchange planned to implement to resolve the matter. In December 2004, the CBOT reported to a meeting of NGFA member country elevator managers what it had done to implement changes. The CBOT will report again at the NGFA convention on March 31 concerning its implementation of changes and resulting market performance improvements.

We do not raise this issue to complain about futures market performance. To the contrary, we think it demonstrates the exchange being highly responsive to its customer base and taking the issues raised by hedger customers very seriously. In our view, all the grain exchanges – Chicago Board of Trade, Kansas City Board of Trade, and Minneapolis Grain Exchange – are actively reaching out to their customer base to receive feedback and respond to needs of market participants. These exchanges realize they are in a competitive world and are making serious effort to provide efficient, liquid markets that serve customer needs.

The 2000 Commodity Futures Modernization Act provided additional regulatory flexibility in the CFTC's regulation of exchanges in all commodities, except for the enumerated commodities (grains, and other agricultural commodities). We are not going to argue that the time has now come for enumerated commodity markets to be treated with the identical regulatory structure as all other markets. However, there is no doubt that greater regulation of enumerated commodity markets creates more hurdles to making

rapid, adaptive changes to respond to perceived customer needs and adds to the cost of operating the exchanges.

Will this create cost-competitive challenges for U.S. exchanges in the future? The U.S. exchanges are in the best position to draw that conclusion. We do think it is to the advantage of the U.S. producer and consumer to have strong, liquid futures markets here in the U.S. to maintain marketing and pricing efficiency. Given the responsiveness of the exchanges to their customer base, we would submit that the agricultural markets should soon be candidates for a more flexible and less costly regulatory structure. The increasing competition in the marketplace tends to provide additional discipline that should eliminate some of the need for regulations under the CFTC.

Greater Legal Clarity for Cash Grain Contracts

The Commodity Futures Modernization Act of 2000 (CFMA) addressed a potentially major problem in non-agricultural off-exchange derivatives markets. It provided legal certainty for such derivative contracts to be legally enforceable after both parties had executed the contract. Because of the growth and growing economic significance of financial derivatives, this action was deemed necessary to give greater assurance of the ongoing performance of huge markets that underpin the functioning of the general economy.

While agricultural markets are considerably smaller than these financial derivative markets, cash agricultural contracts remain saddled with the risk that the CFTC or the court system may review a particular contract and declare after the fact whether the contract is viewed as legal (exempt from CFTC jurisdiction) or illegal, and therefore not enforceable.

We think it is important that the marketplace have more direction from government as to the legal standing for agricultural cash contracts. Increasingly, cash contracts that are offered to farmers have features that provide the farmer and the merchant with greater flexibility. That flexibility has value to both parties. Unfortunately, the flexible features that provide more value and utility are the same contract features that potentially raise questions regarding the contract's legal standing. Contract features such as providing for multiple pricing opportunities, allowing a contract to be rolled forward, and offering the ability to cash settle the contract have real economic value, but depending on the circumstances can raise legal questions. The bottom line is that we think greater legal clarity will provide the marketplace the ability to offer more value through cash contracting.

Since 1996, the most litigated legal issue regarding cash contracting was whether the rolling feature built into cash forward contracts made the contract illegal per se. The vast majority of the cases decided since 1996 found that rolling was a legal feature, but the message to the industry was clear: legal uncertainty creates litigation risk and litigation

risk can be expensive. Even when you "win" you may have to pay legal fees of several hundred thousand dollars to prove the point.

There are two potential ways to resolve the need for greater legal clarity for contracts that are exempt from CFTC jurisdiction. One way is to amend Section 1a(11) to more crisply define exempt forward sales of cash commodities. The other method would be for the CFTC to develop more specific guidance for the cash marketplace that gives consideration to the most recent relevant cases before the CFTC and the Federal Circuit Courts. In our judgment, the latter approach – through a regulatory proceeding at the CFTC – holds considerable promise, given the progress that recent court and CFTC cases have made.

The NGFA sent a letter in January 2005 to Acting Chairman Sharon Brown-Hruska requesting that the CFTC undertake such action, and expressing our interest in participation. A copy of that letter was sent to other CFTC Commissioners. To date, we have received generally positive responses from the CFTC regarding a willingness to actively pursue greater legal clarity. Hopefully that process will be initiated soon. While we are not requesting legislative changes at this time, we would welcome the support and participation by Members of Congress or their professional staff in a CFTC effort to accomplish greater legal clarity through regulation.

We would commend the CFTC for making some progress in the last three years through several individual cases. The courts have also contributed to increased clarity, especially in two cases that were decided by the 7th Circuit U.S. Court of Appeals.

In the so-called Nagel II case, the 7th Circuit Court identified the following criteria as providing necessary and sufficient parameters for cash contracts to be declared fully legal and exempt from CFTC oversight and regulation:

1) The contract specifies idiosyncratic terms regarding place of delivery, quantity, or other terms, and so is not fungible with other contracts for the sale of the commodity;
2) The contract is between industry participants, for example farmers and grain merchants; and
3) Delivery cannot be deferred forever because the farmer must pay a fee for extending (rolling forward) the contract.

Furthermore, in the Zelener case, the 7th Circuit court found that the fundamental difference in futures and cash contracts was <u>not</u> the "delivery" feature (because both futures contracts and cash contracts call for delivery), but was in fact that the futures market essentially was "trading the contract" and the cash contract was trading an actual physical commodity. The Zelener case also raised the issue as to whether the original CoPetro decision that established the "multi-factor" approach so often used by the CFTC was in fact an unnecessary extension of the law in that all that is necessary to find that a contract is exempt is to demonstrate clearly it is the trading of an actual physical commodity and not trading in uniformly defined contracts.

The NGFA's view is that a careful reading of these decisions, along with the decisions of the CFTC on cases concluded in late 2003, can lead to a much better understanding of a clear definition of cash forward contracts that are exempt from CFTC oversight. While we judge corrective legislation to be unnecessary at this time, some refinements of the existing statute could be in order if the regulatory process fails to achieve an adequate solution.

Producer Risk Management: Lower Government Support for Farmers May Create More Need for Risk Management Tools for Producers

As this committee is keenly aware, government budget cuts and the negotiations coming up in the next round of the World Trade Organization could affect the level of government direct support to U.S. farmers. If this occurs, producers may find they have greater need for market-based risk management tools. Given this situation, it seems timely to at least review the market-based risk management tools now available to producers and to make note of regulatory barriers that are today restricting access for some producers.

Attached to this statement is an appendix that provides an inventory of some market-based risk management tools, and offers some judgments as to why these tools may or may not be attractive to producers. Exchange based tools – futures and options markets – provide both a direct way for producers to manage price risk and the foundation for hedging a variety of cash contracts that are offered through merchandising companies. While a growing number of grain and oilseed producers are regularly utilizing exchange-based or cash contracting tools today, reductions in government programs that have traditionally protected against low price situations should create additional demand for such products.

As noted previously, modern cash contracts that are specifically tailored to producers' need for risk management and flexibility can be facilitated further by the CFTC providing greater legal clarity on what terms and flexibility are legally acceptable. Also, while we are not advocating specific changes in agricultural trade options regulations, we do think it is appropriate that Congress be aware of stipulations in current regulations that restrict access to trade options and similar products.

Agricultural trade options (ATOs) were granted regulatory approval in April 1998, but the CFTC rules made the program very expensive and cumbersome to any entity that might have considered becoming licensed under the program. Subsequent refinements have encouraged little participation, and thus far, only one firm is even registered for that program.

While the CFTC's ATO regulations did little to provide new risk management tools to farmers in general, they did have other implications. The rule specifically exempts producers with $10 million in net worth from any of the ATO regulations. Thus, any

producer with a high net worth may have access to a range of potential new risk management tools that are unavailable to moderate-sized producers. While there is some logic to a high net worth being associated with market sophistication (and thus less need for CFTC oversight), given the potential value to producers, the level of restrictions on access to tools may be worthy of consideration.

Additionally, when the CFTC regulations were put into effect, they had a chilling effect on the agricultural swaps market. The exemption level for participating in all swaps markets (both enumerated agricultural commodities and other commodities) was originally set at a minimum of $1 million in net worth. The CFTC's agricultural trade options regulations "clarified" that the minimum net worth for agricultural swaps going into the future was revised, beginning in 1998, to a minimum of $10 million. This regulatory adjustment is known to have halted the use of certain agricultural swap contracts used to hedge price risks with some farm management companies.

Again, at this time, we do not make any specific recommendations on what is the right approach with the CFTC's regulation of trade options or swaps markets. But if, in fact, U.S. producers are confronting reductions in government support, there will be additional need for flexible risk management tools and, thus, a potential reason for reconsidering how either lack of legal clarity or existing regulations may restrict producer access to such tools.

Summary

To conclude, the NGFA strongly supports reauthorization of the CFTC. While we are not currently asking for major legislative changes, we suggest that a dialogue with the CFTC, and perhaps eventually with Congress, should begin to focus on three areas:

1) Futures exchange performance and oversight by the CFTC – and in particular, considering a potentially more flexible regulatory environment for U.S.-based exchanges with regard to agricultural contracts;

2) Greater legal clarity for cash grain contracts, with a view toward minimizing the litigation risk of companies working with producers on marketing strategies, and providing additional flexibility and marketing options for producers; and

3) Examining additional regulatory flexibility to aid producers in their risk management strategies in an era with potentially lower government support for production agriculture.

The NGFA appreciates the opportunity to present our views on the CFTC and related risk management issues in agriculture.

Appendix

Farmer Risk Management Tools: What's Available

The chart on the last two pages of this Appendix summarizes a number of the market-based risk management tools available to producers, including:

1) Exchange-based tools – futures, options;
2) Cash contracts (for crops) – fixed price, minimum price, and other;
3) Agricultural trade options.

A. Exchange-based tools. As the undisputed centerpiece of price discovery and price risk management in grain-based agriculture, exchange futures contracts remain the single most important tool and also provide the foundation for many other risk management tools. Virtually all cash contracts offered to grain farmers are designed so as to permit hedging the risk through exchange instruments. Thus, a high percentage of cash contracting activity establishes a price risk to the buyer that is ultimately "laid off" in futures markets.

Farmers may use futures markets directly to price products and hedge risk, and such tools have distinct advantages that are available only on regulated exchanges: 1) highly liquid markets allowing rapid adjustments in strategies, and are very cost-efficient; 2) guaranteed counter-party performance; 3) transparent pricing of the futures portion of cash price; and 4) mechanisms to price now or later and during periods of "carry" in the market, and to assure returns to farmers for grain storage activities. Exchange options require an up-front premium payment, but have the added feature of locking in an assured minimum futures price while giving the farmer an opportunity to participate in upward price swings. Options, unlike futures, do not require ongoing margining and the total cost is known in advance.

Why aren't exchange-based tools used by more farmers? With all the advantages that exchange-based products offer – many of which cannot be duplicated off-exchange – the question is often asked: Why don't more farmers use futures and options directly? The biggest disincentive to farmer use of futures has been the fact that past (and even some current) government programs contain features that give a free competitive alternative to exchange products. If government continues to deregulate commercial agriculture, there will be some growth in the direct use of futures markets by farmers, but there are reasons to expect the growth to be slow, at best: 1) The government loan rate continues as a free "put" option to the farmer; thus there is little need for the farmer to duplicate (and pay for) this position in the market unless prices are at a level moderately higher than the loan rate; 2) Futures markets only address the "futures" price portion of cash prices; basis levels (difference in central futures price and local cash price) remain a risk to be managed through the use of a separate tool (such as a basis contract); and 3) In the case of futures, the fact that daily "mark-to-market" occurs is beneficial in that the hedger knows his/her position every day, but the accompanying need to finance margin

requirements which can be annoying, or a potential financial risk to protect a hedge in a rapidly changing market. Possibly the most significant disadvantage of direct farmer use is that futures only address a portion (albeit the most significant portion) of price risk.

B. Cash Contracts. In the grain and feed industry, cash contracts that are statutorily exempt from CFTC regulation have traditionally been used to: market physical grain; establish the price (both regulatory futures and basis); and manage price risk within a single product. The defining feature of "exempt" cash contracts (in contrast with regulated futures) is that physical delivery is required and generally occurs. Fixed price cash contracts give the farmer the ability to establish a firm cash price weeks, months, or even years ahead. (The ability to establish forward prices would be greatly impeded, if not impossible, without the existence of the futures markets that offer price quotes and a liquid hedging vehicle for delivery periods months/years in advance.) Minimum price contracts permit the establishment of a minimum cash price but allow the farmer to participate in upward movements in market prices prior to delivery. The mini-max contract, establishes both a minimum and maximum price, thus the farmer knows in advance the best and worst cash price that he can receive for a given crop. Why would a farmer want to set a maximum price? By being willing to "cap" upside potential, the farmer can effectively reduce the premium cost to establish a price floor.[1] The basis contract allows the farmer to establish a fixed basis (difference in futures and local cash price), but permit the establishment of the reference futures price at a later date (presumably when futures are more favorable).

The hedge-to-arrive (HTA) contract is the mirror image of the basis contract: it permits the establishment of a futures contract reference price, and allows the farmer to set a basis level at a later date. Both the basis contract and the HTA are designed to offer "a la carte" marketing flexibility to the farmer – to be able to set futures and basis levels at separate times during the marketing year in an effort to "optimize" both components of the cash price. The delayed price (DP) contract is shown in the table to demonstrate that not all contracts have risk management features. The DP contract is used to transfer title and provides an alternative to storage. It contains no risk management features for farmers.

Why don't more farmers use forward cash contracts? Farmers use cash contracting more frequently than they directly use futures products. There are two principal reasons for this: 1) The ability to do business with someone "local" (the

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[1] *The mini-max contract provides a good example of how various risk management services can be bundled to provide a fairly sophisticated and useful risk management tool, but one which is also readily understandable by the farmer. From the farmer's standpoint, a mini-max contract is straightforward: For a pre-established fee, the mini-max sets a fixed range of possible market prices for his/her crop. However, from the elevator's standpoint, this contract requires the bundling of the following services: 1) hedging futures risk which may entail three simultaneous transactions in futures and options markets [sell futures, buy a call (to establish minimum futures) and sell a call (to establish maximum futures)]; 2) management of cash basis risk; 3) management of financial risk (maintaining financing on the futures position); and 4) providing a physical delivery location for the commodity. Clearly, this bundling of services, and making the "risk profile" of the contract easy to understand by the farmer improves the likelihood that prudent risk management activities will be utilized.*

counter-party risk inherent in cash contracts, which is not present in futures, seems generally insufficient to offset this "local" market advantage); and 2) Cash contracts can provide a more complete risk management/marketing product through a bundling of services. (The most popular product – fixed price forward contract – addresses physical commodity marketing and establishes cash price – both futures and basis. It also includes financial services of margining the account and credit cost exposure.) Even so, farmers do not make as frequent use of forward cash contracts as might seem prudent. One likely reason for this is the requirement to deliver. In the event of crop failure, the farmer's obligation to physically deliver remains in place. This is one of the reasons that many farmers that use cash forward contracts also may use crop insurance tools like MPCI or CRC to assure a minimum level of capacity to acquire physical bushels to be delivered.

C. Agricultural Trade Options: Agricultural trade options (ATOs) are not being widely offered today as only one firm has signed up to provide ATOs under CFTC regulations.

Agricultural trade options are defined here as contracts that establish the right, but not the obligation to deliver a physical commodity, and which can be cash settled at or prior to expiration. The primary feature differentiating an ATO from traditional cash contracts is that there is a clear option for not executing on delivery of the commodity. In agriculture, given the nature of weather risk, the right to "walk away" from delivery for a defined price (the option premium) could be beneficial and could encourage earlier season and more aggressive forward contracting by producers even when the exact size of the producer's crop is unknown.

Summary of Major Risk Management Tools for Grain/Oilseed Producers

	Risks Being Managed	Advantages	Disadvantages
I. Exchange tools			
Exchange Futures	– Price Risk: (futures portion only)	– Liquidity – Daily mark to market – Guaranteed counterparty performance – Central price discovery – Allows assured market earnings for storage	– Addresses only futures prices – Margin calls in rapidly changing market (potential financing risk)
Exchange Put Option (set min futures prices)	– Price Risk: (futures price only; limits downside risk)	– liquidity – ability to cash settle; access to additional time value upon liquidation – no counterparty	– addresses only futures price risk
II. Cash Contracts			
Fixed Cash Forward	– Price Risk: futures and basis risk	– Ability to lock in firm cash price (futures and basis)	– Risk of unexpected large yield loss (required to deliver whether physically produced or not) – Perceived opportunity cost (contracted too early in uptrading market) – Counterparty risk
Minimum Price Contract	– Price risk; futures and basis risk – Limited yield risk management	– Sets minimum price but seller benefits from market rallies	– Counterparty risk – Risk of unexpected large yield loss
Mini-max	– Price risk; futures and basis	– Sets minimum and maximum price	– May limit upside market prices
Basis Contract	– basis risk only	– Permits establishing basis level and futures price at different times (flexibility to attempt to optimize total cash price)	– Leaves the most sizable portion of price risk (futures) open to declines – Counterparty risk

	Risks Being Managed	Advantages	Disadvantages
Hedge-to-Arrive (HTA)	– Futures (virtually equivalent outcome to short futures position)	– Permits establishment of futures & basis at different times – No margin calls	– Counterparty risk – Risk of unexpected yield loss
Delayed Price (DP)	– Manages no risks	– Logistical tool that provides alternative to storage	– Counterparty risk
III. Agricultural Trade Options (ATOs)	– Price (futures and basis) – Yield – Logistical	– Assists the producer in managing yield risk	– Counterparty risk – Regulatory burden on ATOM – Smaller farmers may be unable to participate ($10 million net worth to be exempt)

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