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HEARING TO REVIEW REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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HEARING TO REVIEW REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

WEDNESDAY, OCTOBER 24, 2007

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 1:30 p.m., in Room 1300 of the Longworth House Office Building, Hon. Bob Etheridge [Chairman of the Subcommittee] presiding.

Members present: Representatives Etheridge, Scott, Marshall, Boyda, Herseth Sandlin, Ellsworth, Space, Walz, Pomeroy, Peterson (*ex officio*), Barrow, Moran, Graves, Conaway, Neugebauer, and Goodlatte (*ex officio*).

Staff present: Alejandra Gonzalez-Arias, Tyler Jameson, Scott Kuschmider, Clark Ogilvie, John Riley, Kristin Sosanie, Bryan Dierlam, and Jamie Weyer.

OPENING STATEMENT OF HON. BOB ETHERIDGE, A REPRESENTATIVE IN CONGRESS FROM NORTH CAROLINA

The CHAIRMAN. This hearing of the Subcommittee on General Farm Commodities and Risk Management to review reauthorization of the Commodity Futures Trading Commission will come to order. First, I would like to welcome our witnesses here today and say we are looking forward to your testimony. Also, I want to welcome the other members of the Commodity Futures Trading Commission who are with us today, Commissioner Mike Dunn, Commissioner Jill Sommers and Commissioner Bart Chilton. Your attendance here today is appreciated, showing solidarity with the Acting Chairman, and I know he appreciates it as well.

Today this Subcommittee takes another important step on the road to reauthorization. Last month we heard from a host of industry participants on a wide range of issues affecting the futures markets. Last July we heard from a number of witnesses including the two who will testify today about energy trading and the developments that have been occurring in these specific markets. Today it all comes together. The recent report from GAO, of which Ms. Williams will testify, provides us with a clearer picture of what is happening in the energy markets. While the report does not include specific legislative recommendations, it does suggest that Congress may want to examine the regulatory structure for some

of these markets. Something I am confident we would be doing even in the absence of the report.

From the CFTC we will be hearing their recommendations on a number of issues. Most importantly we will be receiving results of their own examination of energy markets. I look forward to exploring further the Commission's recommendations during the question and answer period.

In last month's hearing several witnesses expressed a great deal of anxiety regarding recent FERC action, as it may be encroaching upon the CFTC's exclusive jurisdiction over the futures markets. While not exactly a topic usually considered under reauthorization, I suspect some Members will use the opportunity of this hearing to hear directly from the CFTC regarding this matter. As I stated at that hearing, it was Congress' intent that the CFTC should have exclusive jurisdiction over futures markets to provide certainty in the markets on the rules that apply to those markets. For the CFTC to fail to assert its exclusive jurisdiction when appropriate would not only jeopardize the success that we have seen in the futures markets since passage of the CFMA, but also equal a failure to uphold the will of the United States Congress.

Again, I want to thank the witnesses for their participation and now I turn to the gentleman from Kansas, Mr. Moran, for his opening statement.

OPENING STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Mr. MORAN. Mr. Chairman, thank you very much.

This is an important and useful hearing and I will leave my remarks to be very brief. It is axiomatic that no elected official is ever short of words but we have had reauthorization hearing after reauthorization hearing, and opening statement after opening statement by the two of us, and I think both of us are very anxious to reach a consensus and reach a conclusion and move forward as quickly as possible on reauthorization legislation both here in the House, and ultimately in the Senate, and signed by the President. I appreciate again this hearing.

Mr. Lukken, I appreciate your testimony. I thought it was very precise and I appreciate the exact instructions. Sometimes we get witnesses who in some ways hedge their recommendations to us and you did not do that and I am grateful for that. I, also, would like to take the opportunity to point out that we have a long history in Kansas for providing personnel to be Commissioners at the CFTC and I welcome Jill Sommers, our latest Kansas addition to your Commission. I look forward to working with her, the other Commissioners, and you, Mr. Chairman. I look forward to hearing what Ms. Williams has to say and I am anxiously awaiting the testimony of both of you. Thank you very much.

[The prepared statement of Mr. Moran follows:]

PREPARED STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Thank you Mr. Chairman. It is a pleasure to be here as we continue toward reauthorization of the Commodity Exchange Act. Today we have two expert witnesses to report on possible ways to improve the Act during reauthorization. I look forward

to hearing the suggestions of both Acting Chairman Lukken and Ms. Williams from the Government Accountability Office.

The CFTC has continued to operate far too long without proper reauthorization and sufficient funding. In recent years markets have evolved and trading volume increased exponentially. It is essential the Committee listen carefully to the suggestions of today's witnesses and those of industry participants from the September 26, 2007, hearing held by this Subcommittee, and move toward reauthorization as soon as possible so the CFTC has the tools necessary to properly oversee markets.

Thank you, Acting Chairman Lukken and Ms. Williams, for your testimony today.

The CHAIRMAN. I thank the gentleman. He yields back.

Now I would turn to the Chairman of the full Committee, Mr. Peterson, for his opening statement.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman, and thank you for calling this hearing today and for the work you have been doing to keep the Committee on track regarding the Commodity Exchange Act reauthorization. As everybody knows, we have been busy all year trying to get the farm bill done but reauthorization of this Act is another major responsibility for this Committee. I commend you and Mr. Moran and others for the work that you have done with the series of reauthorization hearings. We need to get this reauthorization done and signed into law.

I would like to welcome today as witnesses, Mr. Lukken and Ms. Williams. I appreciate you being with us. Mr. Lukken chaired a hearing at CFTC on September 18 regarding many of the issues this Committee will consider during the reauthorization. I look forward to his input as we continue this process.

Our Committee considers reauthorization at a time when the futures markets are changing with increased volume and tradable products. In the 7 years since the passage of the Commodity Futures Modernization Act we have seen growth in trading volume, number of participants and new trading products having grown beyond the price hedging of physical commodities to include a wide selection of highly complex financial products and indicators. I am sure from CFTC's perspective gathering data on these newer but still heavily traded products is not always easy and the that effective oversight is a real challenge.

Last month the CFTC held a meeting about the oversight of exempt commercial markets and their effect on traditional futures exchanges. I notice in Mr. Lukken's testimony that the CFTC proposes increased oversight over the ECMs when certain conditions are met. I am grateful to the Commission for providing specific recommendations in this area and can assure that the Committee will give serious consideration to the points that you have raised.

Ms. Williams will present the GAO's findings about energy derivative transactions and some of those exempt trading platforms and the CFTC's limited oversight in that venue. Given some of the more publicized events that we have seen with energy trading it would appear to the layperson that there are separate markets out there that appear to be similar but are playing under different rules. I hope Mr. Lukken can shed some light from CFTC's perspective on what exempt commercial markets can offer the marketplace in terms of price discoveries and innovations.

So it is my hope that today's hearing will giving us a good understanding of what needs to be done in this reauthorization in order to continue to ensure the integrity of our futures markets. I would, again, welcome today's witnesses and appreciate the time.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you, Chairman Etheridge, for calling this hearing today and for the work you have done keeping this Committee on track regarding Commodity Exchange Act reauthorization. We have been busy all year trying to get the farm bill done, but reauthorization of this Act is another major responsibility for this Committee and I commend you for the work you have done with this series of reauthorization hearings. We need to get this reauthorization done and signed into law.

I would like to welcome today's witnesses: Acting CFTC Chairman Walter Lukken and Ms. Orice Williams with the Government Accountability Office.

Mr. Lukken chaired a hearing at CFTC on September 18, regarding many of the issues this Committee will consider during CFTC reauthorization and I look forward to his input as we continue that process.

Our Committee considers CEA reauthorization at a time when futures markets are changing with increased volume and tradable products. In the 7 years since the passage of the Commodity Futures Modernization Act, we have seen growth in trading volume, numbers of participants, and new trading products, having grown beyond the price hedging of physical commodities to include a wide selection of highly complex financial products and indicators. I'm sure from the CFTC's perspective, gathering data on these newer, but still heavily-traded products is not always easy, and that effective oversight is a real challenge.

Last month, the CFTC held a meeting about the oversight of exempt commercial markets, or ECMs, and their effect on traditional futures exchanges. I notice in Chairman Lukken's testimony that the CFTC proposes increased oversight for ECMs when certain conditions are met. I am grateful to the Commission for providing specific recommendations in this area and can assure it that the Committee will give serious consideration to the points you have raised.

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It is my hope that today's hearing will give us a good understanding of what needs to be done in this reauthorization in order to continue to ensure the integrity of the futures markets.

I would again like to welcome today's witnesses and I yield back my time.

The CHAIRMAN. I thank the gentleman.

Ranking Member of the full Committee, Mr. Goodlatte.

OPENING STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM VIRGINIA

Mr. GOODLATTE. Mr. Chairman, thank you. I want to commend you for holding this hearing and the work that you and Mr. Moran and the Chairman and others have done on the Commodity Futures Trading Commission through authorization. I want to welcome our witnesses.

The last reauthorization began in May of 1999 and resulted in three committees working for more than a year to report legislation to amend the Commodity Exchange Act and Federal securities law. Hopefully, this reauthorization will be significantly less complicated and controversial. Granted some areas of controversy still exist in the areas of energy derivatives, sales of off-exchange forex instruments, single stock futures regulation and the continuing

globalization of electronic trading. I am hopeful, however, that we can sort these matters out by carefully considering the testimony submitted to this Committee. I am also confident in the CFTC's ability to police the derivatives markets. I believe the Commodity Futures Modernization Act set a course for the wise use of an array of risk management instruments by large and small businesses alike. While forming the basis of sound business practices in different venues these instruments also remain cost-effective. Additionally, I am heartened by the steady rise in the trading volumes on our Nation's futures exchanges. The increased trade volumes provide evidence that our exchanges still offer a unique product that may be used efficiently and with reasonable safety. I also assume that rising volume numbers mean that financial services firms offering tailored over-the-counter products to their customers are laying some of their risk off on the organized exchanges.

This morning, the CFTC released, *Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets.* This report is the result of CFTC's hearing on this topic, economic analysis by the Office of Chief Economist, and the CFTC's internal deliberations and expertise on futures trading. I commend the CFTC for investing the resources needed to develop the recommendations and I look forward to Chairman Lukken expanding on them in his testimony.

I, again, thank you for the opportunity to offer some of my thoughts on this important undertaking and look forward the testimony of the witnesses. Thank you, Mr. Chairman.

[The prepared statement of Mr. Goodlatte follows:]

PREPARED STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM VIRGINIA

Mr. Chairman, I want to commend you for holding this hearing today, and continuing the Committee's work on the Commodity Futures Trading Commission's reauthorization.

The last reauthorization, which began in May of 1999, resulted in three committees working for more than a year to report legislation to amend the Commodity Exchange Act and Federal securities law. Hopefully, this reauthorization will be significantly less complicated and controversial.

Granted, some areas of controversy still exist in the areas of energy derivatives, sales of off-exchange forex instruments, single stock futures regulation, and the continuing globalization of electronic trading. I am hopeful, however, that we can sort these matters out by carefully considering the testimony submitted to this Committee.

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Thank you for the opportunity to offer some of my thoughts on this important legislative undertaking and I thank the witnesses for testifying here today.

The CHAIRMAN. Thank you, sir.

The Chair would request that other Members submit their opening statements for the record so that the witnesses may begin their testimony and ensure that we have ample time for questions.

[The prepared statements of Mr. Walz and Mr. Graves follow:]

PREPARED STATEMENT OF HON. TIMOTHY J. WALZ, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. Chairman, thank you for holding this hearing today on the reauthorization of the Commodity Futures Trading Commission.

Since 1974, when the CFTC began to oversee trading in derivatives, it has been necessary for the CFTC to strike an appropriate balance to find the "sweet spot" of regulation that would protect investors but not stifle the industry.

I am particularly interested to hear testimony today from Acting Chairman Lukken about foreign currency exchanges. Three years ago, the *Zelener* case limited the CFTC's ability to address foreign currency fraud and the question of what type of authority the CFTC should possess in this area is an important issue for many in the forex market.

I have met with some of the stakeholders who are involved in the forex market and I believe I can speak to the perspective of many of them. They do not fear government regulation, they welcome it.

Forex traders realize that there is a role for the government to play in creating a level playing field and making sure everyone plays by the rules. But what they do not want is heavy-handed regulation that will squelch a new market that is widely used by many investors overseas, but is just getting its footing in the United States.

I think it is very important that Congress get this question right. It should not be our goal to treat every commodity the same when it comes to regulation. It should not be our goal to interfere with a market that is operating fairly and efficiently.

Mr. Chairman, I look forward to the opportunity to hear the testimony of our witnesses today and the chance to ask them questions about how they believe forex regulation should be addressed.

PREPARED STATEMENT OF HON. SAM GRAVES, A REPRESENTATIVE IN CONGRESS FROM MISSOURI

I want to thank the Chairman and Ranking Member for having this hearing today. I appreciate the opportunity to submit remarks to the record.

Last month we heard from industry folks on reauthorization of the Commodity Exchange Act and they provided some useful insight on how we should proceed. Today, I look forward to hearing the recommendations of the Commodity Futures Trading Commission (CFTC) and working with them as we begin the reauthorization effort.

I have reviewed Chairman Lukken's testimony and I am very pleased with some of the changes he is recommending, particularly in exempt commercial markets and in over-the-counter markets. I agree with his conclusion that more transparency is better for all parties involved. Additionally, I am pleased with the new position reporting recommendations he is suggesting and look forward to working with him and his staff along with the industry folks as we begin consideration of this important legislation.

Last, I ask the CFTC to please comment on H.R. 3009, the Market Transparency Reporting of United States Transactions Act of 2007 that I introduced.

I look forward to listening to the panelists today and moving forward with this reauthorization.

The CHAIRMAN. We would like to welcome now to the panel, to the table our panelists, the Honorable Walter Lukken, Acting Chairman of the Commodity Futures Trading Commission and Ms. Orice Williams, Director of Financial Markets and Community Investment for the U.S. GAO. That's the United States Government

Accountability Office. Mr. Lukken, please begin when you are ready and I would request if you would, please, try to summarize your full statement and each of your full statements will be entered into the record.

STATEMENT OF THE HON. WALTER LUKKEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. LUKKEN. Thank you, Mr. Chairman. Good afternoon, Chairman Etheridge, Ranking Member Moran and Members of the Subcommittee. I am pleased to appear on behalf of the Commodity Futures Trading Commission to discuss important issues surrounding our reauthorization.

Seven years have passed since the passage of the Commodity Futures Modernization Act. During that expanse of time, significant changes occurred within the futures industry. Since 2000, annual growth volume on U.S. futures exchanges have increased 442 percent. New exchanges are being created and new products are being invented on a daily basis. But perhaps the greatest shift in the futures industry is the undeniable fact that our markets are global. For firms and exchanges this is welcome news—more growth opportunities than ever before. But for regulators, this global repositioning means we must rethink how we do our jobs and adapt appropriately.

Thankfully, with the passage of CFMA, Congress had the foresight to provide this agency with the tools needed to oversee this rapidly changing marketplace. Much has been made of the flexibility provided by the CFMA, but the adoption of a core principles approach equally enhanced the Commission's ability to get in front of the developing regulatory problems. At a time of scarce resources, this has allowed the CFTC to target our efforts effectively to areas where the risks to the public are the greatest. And I am pleased to report that, by and large, the legal framework of the CFMA is working extraordinarily well.

That said, regulators and lawmakers cannot anticipate every evolution of these markets. With this recognition, I come before you today to discuss two broad areas for consideration. First, based on recommendations from the Commission presented today, Congress may wish to evaluate whether enhancements are necessary for the legal framework provided for exempt commercial markets. Second, Congress may want to review whether the CFTC has adequate authority to police retail fraud, particularly in the foreign currency area, and whether the penalty scheme for market manipulation reflects the severity of this economically disruptive behavior.

The CFMA created a tiered regulatory structure for the futures industry which tailored requirements to the specific risks of the marketplace. Within this tiered design Congress created a light-touch regulatory category called exempt commercial markets or ECMs on which certain commodities such as energy products could be traded by institutional participants. Due primarily to the non-retail nature of these markets and the types of transactions executed policymakers believe the risks associated with the wholesale exchanges to be low.

However, the energy markets have changed dramatically in the past 7 years and the Commission's regulation of these markets should evolve in kind. Although these exempt markets have increased competition, certain energy contracts offered on ECMs now function as virtual substitutes for contracts listed on regulated exchanges.

Last month, the Commission convened a hearing to examine the oversight of trading on designated contract markets and ECMs. Commission staff, exchanges, ECMs, and industry and consumer groups testified before the Commission in a productive debate. Based on this hearing, the Commission presents to this Committee a report today detailing the Commission's findings and recommendations regarding these energy markets.

As the Committee knows, under the CEA price discovery is the key determinate to Commission regulation, as others outside the marketplace begin to use prices to conduct business, such as farmers, utilities and others. Similarly, price discovery was the primary focus when the Commission began its review of ECMs.

Testimony from the Commission's hearing and staff analysis on this subject has led us to conclude that certain natural gas products on the InterContinental Exchange and NYMEX function as virtual substitutes. Not only are the products substantially identical in terms and pricing, but the market participants are also the same, with all of the top 25 natural gas traders on NYMEX also trading significantly on ICE. Moreover, our economic analysis by staff show that trading activity in these products on ICE serves a significant price discovery function on 20 percent of the trading days measured.

Many witnesses from the hearing testified that ECMs provide a valuable platform for markets seeking a low-cost, effective "on-ramp" to launch new ideas for contract design and trading. However, the reality that some ECM contracts are serving a significant price discovery function leads the Commission to conclude that changes to the CEA may be necessary.

To that end, the Commission recommends that the CEA be amended so that when an ECM futures contract is determined to serve a significant price discovery function the Commission would have the authority to: one, require large trader position reporting for that contract; two, require an ECM to adopt position limits or accountability levels for that contract; three, an ECM to exercise self-regulatory responsibilities over that contract in preventing manipulation; and four, exercise emergency authorities regarding such transactions.

These recommendations have the support of the entire Commission and will allow the agency to properly oversee price discovery contracts while keeping in place the tiered regulatory structure that has fostered innovation and competition in these global markets. As a member of the President's Working Group on Financial Markets, I have fully consulted with my colleagues on the Working Group regarding these recommendations and they are comfortable with our leadership on this issue.

I now want to turn to another reauthorization matter, the issue of retail fraud in foreign currency trading. In 2004, the 7th Circuit curtailed the Commission's ability to combat retail off-exchange for-

eign currency fraud. In the *Zelener* case, the court held that contracts at issue were not futures contracts, but rather a rolling spot contract that could not be the basis for CFTC fraud action. This has provided a potential road map to scam artists for evading the CFTC's fraud authority.

In the last 7 years, The CFTC has brought 98 enforcement actions involving forex fraud and has been awarded more than $1 billion in penalties involving more than 26,000 victims. Recently, however, because of the *Zelener* decision, the Commission has lost some key forex cases and now finds it more difficult to prosecute forex actions. Unless Congress clarifies the Commission's jurisdiction in this area, a large sector of retail fraud will remain effectively outside of the prosecutorial authority of the CFTC. The Commission believes that the consensus PWG language included in this Committee's last reauthorization would substantially address this problem.

The Commission also asks Congress to clarify that the CFTC has fraud authority regarding off-exchange "principal-to-principal" futures transactions. This is necessary to clarify our fraud authority regarding non-intermediated trades in light of a court decision that clouded our authority in this area. The House reauthorization bill of 2005 included language addressed this problem.

In addition, the Commission asks Congress to enhance its penalty scheme for market manipulation to reflect the economic severity of such activity by increasing the maximum fine to $1 million per violation and the maximum prison sentence to 10 years.

As the futures markets have grown in size and complexity, the Commission continues to evolve in kind using the regulatory tools provided by the CFMA and this Committee. However, the Commission's funding has remained static over the last few years while staffing levels have been decreasing to historic lows. The Commission has always done more with less but is currently stretched to the limit. In reauthorization, I am hopeful that Congress will support sufficient funding for the CFTC at a level that matches its regulatory expectations for this agency and the growth of these markets.

I greatly appreciate the opportunity to testify before you today and look forward to any questions the Committee may have.

[The prepared statement of Mr. Lukken follows:]

PREPARED STATEMENT OF HON. WALTER LUKKEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning Chairman Etheridge, Ranking Member Moran and Members of the Subcommittee. 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 Commodity Exchange Act (CEA), the Commission's governing statute.

Seven years have passed since the passage of the Commodity Futures Modernization Act (CFMA). During that expanse of time, significant change has occurred within the futures industry. In the past 7 years, the annual volume on U.S. futures exchanges increased 442 percent. This industry has witnessed accelerated migration from open outcry trading to electronic platforms, with screen-based trading now accounting for a significant majority of all futures volume. New exchanges are created and new products are invented on a daily basis. But perhaps the greatest shift in the futures industry is the undeniable fact that our markets are global. Advances in technology have expanded the playing field to include every place in which there are people who wish to participate. For firms and exchanges, this is welcome news—

more growth opportunities than ever before. For the marketplace, it means increased liquidity and information coming into the price-discovery process. But for regulators, this global repositioning means we must rethink how we do our jobs and adapt appropriately.

Thankfully, with the passage of the CFMA, Congress had the foresight to provide this agency with the flexible tools needed to oversee this rapidly changing marketplace. Before the principles-based regime implemented by the CFMA, some of the prescriptive rules written by the CFTC were virtually outdated on the day they were published. This was not the fault of the agency, but the reality of the marketplace. The nature of these markets is to innovate, compete and arbitrage opportunities with lightning speed. In crafting the CFMA, policymakers recognized that, instead of struggling against this dynamic, a regulatory structure should leverage these market characteristics to the advantage of the public interest and allow the agency to better anticipate change.

Much has been made of the flexibility provided businesses by the CFMA, but the adoption of a core principles approach equally enhanced the Commission's ability to get in front of developing regulatory problems. At a time of scarce resources, this has allowed the CFTC to target our efforts effectively to areas where the risks to the public are greatest. Although global growth has made the agency busier now than at any time in its history, the principles-based approach adopted in the CFMA has been remarkably dynamic. I am pleased to report that, by and large, the legal framework of the Act is working extraordinarily well and no major revisions of the Act are needed.

That said, regulators and lawmakers cannot anticipate every evolution of these markets. With this recognition, I come before you today to discuss two broad areas on which Congress may wish to focus during the reauthorization process. First, based on recommendations from the Commission presented today, Congress may wish to evaluate whether enhancements are necessary for the legal framework provided for exempt commercial markets. Second, Congress may want to review whether the CFTC has clear and adequate authority to police fraud, particularly in the foreign currency area, and whether the penalty scheme for market manipulations reflects the severity of this economically disruptive behavior.

Exempt Commercial Markets

The CFMA created a tiered regulatory structure for the futures industry, which tailored regulatory requirements to the specific risks of the marketplace. This calibrated structure has provided the CFTC with flexibility and focus as we strive to keep pace with this industry's global growth.

Within this tiered design, Congress created a light-touch regulatory category called Exempt Commercial Markets or ECMs, on which certain commodities, such as energy products, could be traded by institutional participants. Due primarily to the non-retail nature of these markets and the types of transactions executed, policymakers believed the risks associated with these institutional exchanges were low.

However, the energy markets have changed dramatically in these 7 years and the Commission's regulation of these markets should evolve in kind. Although these exempt markets have increased competition and lowered costs for derivatives trading, certain energy contracts offered on ECMs now function as virtual substitutes for contracts listed on regulated exchanges, with tight correlation and linking of prices and participants.

With this as a backdrop, last month the Commission convened a hearing to examine the oversight of trading on designated contract markets (DCMs) and ECMs. Commission staff, exchanges, ECMs, and industry and consumer groups testified before the Commission in a productive debate of the relevant issues. Based on this hearing, the Commission presents to this Committee a report detailing the Commission's findings and recommendations regarding these energy markets.

Today, I want to highlight some aspects of the Commission's hearing and the resulting findings and recommendations. As the Committee knows, Section 3 of the Commodity Exchange Act provides that the public interest is served through the proper regulation of markets that serve a price discovery function in interstate commerce. Price discovery is the key determinant to Commission regulation and oversight, as others outside the marketplace begin to use prices to conduct business, such as farmers, utilities and others. Similarly, price discovery was the primary focus of this agency when the Commission began its review of the regulatory structure of ECMs.

Although ECMs have been evolving over time, the relatively recent linkage of ECM contract settlement prices to DCM futures contract settlement prices raises the question of whether the CFTC has the necessary authority to police these markets for manipulation and abuse. Linkage of contract settlement prices was not con-

templated at the time of the CFMA nor at the time of the Commission's 2004 rulemaking regarding ECMs that perform a significant price discovery function. The CFTC staff is concerned that ECM cash-settled "look-alike" contracts could provide an incentive to manipulate the settlement price of the underlying DCM futures contract to benefit positions in the "look-alike" ECM contract.

Testimony from the Commission's hearing and staff analysis on this subject has led us to conclude that one ECM, the InterContinental Exchange (ICE), is serving a significant price discovery role and that ICE and the New York Mercantile Exchange (NYMEX) function as virtual substitutes for each other in certain key products. Not only are the products substantially identical in terms and pricing, but the market participants are also the same, with all of the top 25 natural gas traders on NYMEX also trading significantly on ICE. Moreover, economic analysis by our staff indicates that the trading activity in these products on ICE serves a significant price discovery function on 20 percent of the trading days measured.

Many witnesses from the hearing testified that ECMs provide a valuable platform for markets seeking a low-cost, effective "on-ramp" to launch new ideas for contract design and trading methodologies. ECMs serve as incubators for new concepts and provide robust competition with DCMs. This competition has spurred established DCMs to respond to ECM initiatives with innovations of their own, whether it is developing new products or accelerating the pace of automation.

However, the reality that some ECM contracts are serving a significant price discovery function leads the Commission to conclude that changes to the CEA are necessary in order for the Commission to detect and prevent manipulation in these markets.

It is critical that any legislative changes should not result in stifling the innovation and other benefits brought about by ECMs, that changes should not overcomplicate all already complicated statutory regime set out in the CEA, and that changes should be cost-effective for the Commission and industry to implement.

To that end, the Commission recommends that the CEA be amended such that, upon a determination that an ECM futures contract serves a significant price discovery function, the Commission would have four new authorities: (1) Require large trader position reporting for that contract; (2) Require an ECM to adopt position limits or accountability levels for that contract; (3) Require an ECM to exercise self-regulatory responsibility over that contract in preventing manipulation; and (4) Provide the ECM and the Commission with emergency authority over that contract.

These recommendations have the support of the entire Commission and will allow the agency to oversee price discovery contracts while keeping in place the tiered regulatory structure that has fostered the innovation necessary for U.S. markets to compete effectively in the highly competitive global marketplace. As a member of the President's Working Group on Financial Markets (PWG), I have fully consulted with my colleagues on the PWG regarding these recommendations.

In its report, the Commission recommends two other steps to keep abreast of the developing energy markets. First, the Commission recommends the agency establish an Energy Markets Advisory Committee to conduct periodic public meetings on issues affecting energy producers, distributors, market users and consumers in attempt to facilitate discussion and policy decisions as these markets evolve.

Second, the Commission proposes that the CFTC and the Federal Energy Regulatory Commission (FERC) work together to develop best practices for utilities and others who use NYMEX settlement prices as benchmarks in pricing their energy products. Our agencies should also help develop best practices for these end-users of energy on how to utilize the futures and other derivatives markets in managing price risk and volatility.

Today, the Commission also announced it has finalized its amendment to Regulation 18.05 clarifying its ability to obtain information from large traders in regulated markets regarding the full scope of their related positions, including over-the-counter transactions. This transparency serves as an important complement to the recommendations advanced today.

I am confident that the Commission proposal strikes the right balance of ensuring that these markets remain free of manipulative conduct while allowing the markets to grow and innovate on U.S. soil.

The *Zelener* Decision/Foreign Currency Fraud

In our commitment to protecting market participants and market integrity, I want to turn to the issue of retail fraud in foreign currency trading. In 2004, the Seventh Circuit Court of Appeals curtailed the Commission's ability to combat retail off-exchange foreign currency (forex) fraud. In the *Zelener* case, the court held that the contracts at issue were not futures contracts, but rather a type of spot contract that could not be the basis for a CFTC fraud action. This has provided a potential

road map to scam artists as to how to deceive innocent retail customers while evading enforcement by the CFTC.

The CFTC believes that the *Zelener* case and others that have followed it were incorrectly decided and that the contracts at issue are futures contracts. Rather than continue to expend scarce Commission resources litigating this issue, however, we present to Congress the opportunity to restore legal certainty by clarifying the CFTC's jurisdiction in this area.

In the last 7 years, the CFTC has brought 98 enforcement actions involving forex fraud against unsuspecting retail customers. In these 98 cases, there were approximately 26,000 victims who invested approximately $461 million. Courts have awarded more than $1 billion ($1,000,917,086) in customer restitution and civil penalties in these cases. However, because of the *Zelener* decision and its progeny, the Commission has lost some key forex cases and now finds it is more difficult to prosecute forex actions. Unless Congress clarifies the Commission's jurisdiction over off-exchange forex transactions, a large sector of retail fraud will remain effectively outside of the prosecutorial authority of the CFTC.

In November 2005, the PWG submitted to Congress a narrowly tailored proposal to allow the Commission to prosecute forex fraud cases. The proposal would require those who participate in the solicitation of retail forex transactions to register with the CFTC. It would also close a loophole that allowed firms to notice register as securities broker-dealers and serve as counterparties to off-exchange forex transactions. Last, the proposal would bolster the CFTC's anti-fraud authority over retail off-exchange forex transactions like those in dispute in the *Zelener* case. This narrow fix is endorsed by the PWG and was included in the reauthorization bill that this Committee and the House of Representatives passed in 2005.

Principal-to-Principal Antifraud Authority

The Commission also submits to this Committee that it may wish to address an important issue relating to the CFTC's antifraud authority for futures contracts. Congress should clarify that CEA Section 4b, the CFTC's main antifraud provision, gives the CFTC the authority to bring fraud actions in off-exchange "principal-to-principal" futures transactions. This clarification is necessary to eliminate a potential obstacle to the use of the CFTC's antifraud authority in today's non-intermediated markets.

In late November 2000, the Seventh Circuit Court of Appeals suggested that the CFTC may be able to use Section 4b only in "intermediated" transactions—*i.e.*, those involving a broker-customer relationship. In other words, the court indicated that the CFTC may not be able to use its Section 4b antifraud authority in principal-to-principal transactions. Meanwhile, at about the same time, the CFMA was enacted to permit off-exchange futures transactions entered into on a principal-to-principal basis, such as energy transactions pursuant to CEA Sections 2(h)(1) and 2(h)(3). Congress specifically reserved the CFTC's Section 4b antifraud authority in Section 2(h) of the CEA so that the CFTC could prosecute fraud involving transactions conducted under that Section. Since *all* Section 2(h) transactions *must* be done on a principal-to-principal basis to qualify for the exemption, it is important to clarify that the CFTC's Section 4b antifraud authority applies to these non-intermediated transactions. Without this clarification, the work of Congress in 2000 to protect energy markets from fraud could be rendered meaningless.

Accordingly, the House reauthorization bill of 2005 would have amended subsection 4b(a)(2) by adding the words "or with" in order to address off-exchange principal-to-principal transactions. This new language would make it clear that the CFTC has the authority to bring antifraud actions in off-exchange, principal-to-principal futures transactions, including exempt commodity transactions in energy under Section 2(h). This amendment to Section 4b would implement Congressional intent to reserve the CFTC's antifraud authority with regard to these transactions.

I note that the Section 4b language was supported by the Futures Industry Association, the National Futures Association, the Chicago Mercantile Exchange, the Chicago Board of Trade, the NYMEX, USFE, and others during the last attempt at reauthorization.

In addition, the Commission asks Congress to enhance its penalty scheme for market manipulation to reflect the economic severity of such activity as well as the importance of protecting these markets. The Commission recommends amending the CEA to increase the civil and criminal penalties available for certain violations of the CEA such as manipulation, false reporting, and conversion. The maximum fines under Section 9 should be increased to $1 million, and the maximum prison sentence should be increased from 5 to 10 years. The Commission also recommends certain conforming amendments to the enforcement provisions in Sections 6(c), 6b, and 6c of the CEA to effectuate this increase in civil monetary penalties. Increasing the

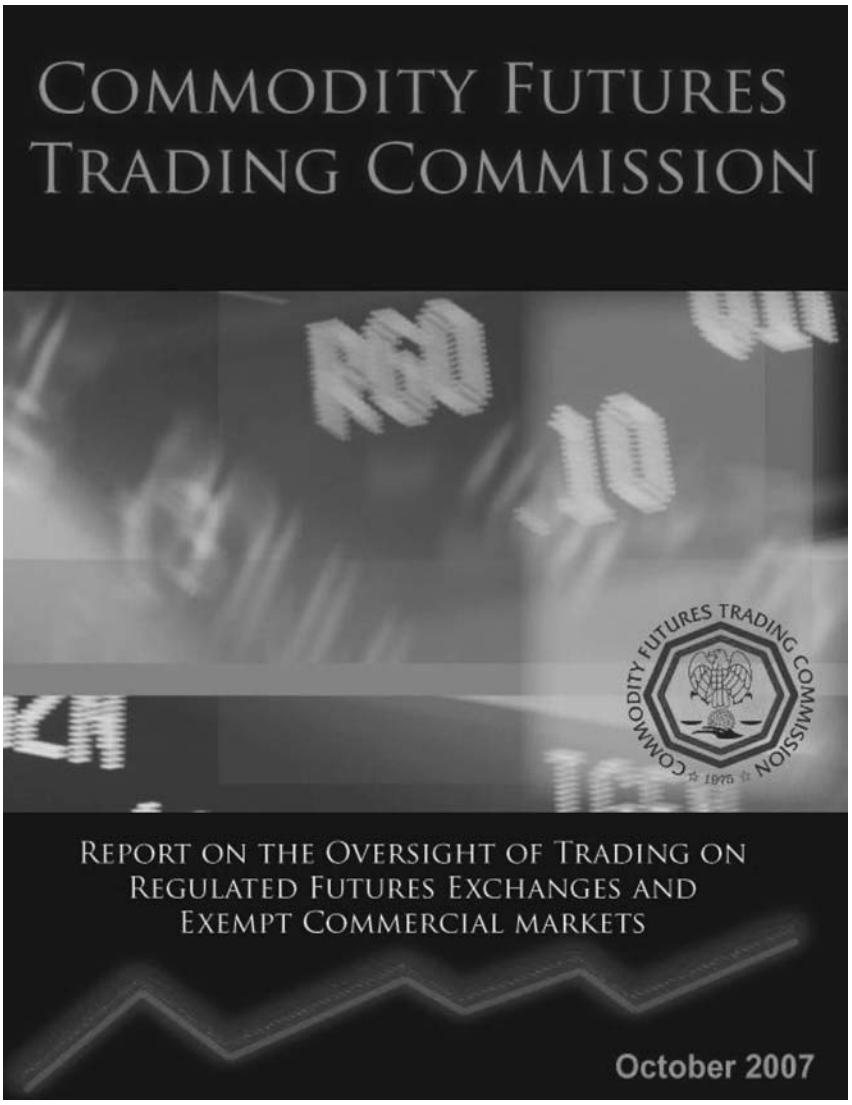
civil penalties that may be imposed for manipulation to $1 million would conform the CEA to the penalty provisions that Congress enacted in the Energy Policy Act of 2005 for manipulation cases brought by the FERC with respect to the physical energy markets.

Conclusion

The CFTC has been able to work within the current structure of the CEA to oversee futures markets, to ensure the integrity of the price discovery mechanism, to maintain the financial integrity of the markets, and to protect customers. The CFTC stands ready to offer its assistance as Congress moves through the reauthorization process and considers these various options.

As the futures markets have grown in size and complexity, the Commission continues to evolve in the administration of its duties. However, the Commission's funding has remained static over the past few years, while staff levels have decreased to historically low levels. The Commission has always done more with less, but it is currently stretched to the limit. In reauthorization, Congress should be mindful of the resources that are needed to fulfill the Commission's mandate. I am hopeful that Congress will support sufficient funding of the CFTC at a level that matches its regulatory expectations for this agency and the growth of these markets.

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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1975
REPORT ON THE OVERSIGHT OF TRADING ON
REGULATED FUTURES EXCHANGES AND
EXEMPT COMMERCIAL MARKETS
October 2007

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I. Executive Summary

On September 18, 2007, the Commodity Futures Trading Commission (CFTC or Commission) held a hearing to examine the oversight of trading on regulated futures exchanges (designated contract markets or DCMs) and exempt commercial markets (ECMs). Witnesses included Commission staff, representatives of DCMs and ECMs, and representatives of a broad spectrum of market users and consumers.

ECMs came into being through the Commodity Futures Modernization Act of 2000 (CFMA), which amended the Commodity Exchange Act (CEA or Act) and replaced the "one-size-fits-all" supervisory framework for futures trading with a risk-based, tiered structure in which the level of regulation is tailored to the type of market and the risks associated with it. While there are small start-up ECMs, some ECMs have taken on the characteristics of DCMs. Of particular note to Commission staff is the development by the InterContinental Exchange (ICE) of a "look-alike" natural gas contract with a settlement price linked to the settlement price of the New York Mercantile Exchange (NYMEX) natural gas benchmark futures contract. Such linkage increases the possibility that the ECM contract is serving a significant price discovery role and could provide incentive to manipulate the settlement price of the DCM contract.

The Commission's hearing focused on a number of issues, including the tiered regulatory approach of the CFMA and whether this risk-based model is beneficial; the similarities and differences between ECMs and DCMs; the associated regulatory risks of each market category; the types of regulatory or legislative changes that may be appropriate to address identified risks; and the impact that regulatory or legislative changes might have on the U.S. futures industry and the global competitiveness of the U.S. financial industry.

While many testified that the tiered regulatory structure of the CFMA was successful and should not be eliminated, witnesses also described concerns associated with the current regulatory structure governing ECMs and the regulatory disparity between DCMs and ECMs. Witnesses raised concern that this disparity increased the susceptibility of the markets to manipulation and disadvantaged the competitive posture of regulated exchanges that offer virtually identical products. Generally, most witnesses believed that some changes to the ECM provisions may be appropriate, as long as they are prudently targeted and do not adversely affect the ability of established ECMs to innovate and grow.

Based upon the hearing and its experience and expertise in these areas, the Commission finds that the risk-based, tiered approach has operated effectively. ECMs have proven popular for new start-up markets and have provided competition for DCMs, spurring them toward innovations of their own.

To the extent that trading volume on an ECM contract remains low and its prices are not significantly relied upon by other markets, the current level of regulation is appropriate. When an ECM contract matures and begins to serve a significant price discovery function for transactions in commodities in interstate commerce, the futures contract warrants some increased oversight to deter and prevent price manipulation or other disruptions to market integrity. This

also will help to ensure "fair competition" among certain ECMs and DCMs that are trading similar products and are vying for the same business.

Based upon the foregoing, the Commission recommends the following legislative changes for ECM contracts that are determined to serve a significant price discovery function:

1. **Large Trader Position Reporting** - An ECM contract that is determined to serve a significant price discovery function should be subject to large trader position reporting requirements comparable to those that currently apply to all DCM contracts. A large trader reporting system would enable the Commission's market surveillance staff to monitor positions on a daily basis to detect and deter possible manipulative schemes.

2. **Position Limits and/or Accountability Level Regime** - An ECM should be required to adopt position limits or accountability levels, as appropriate, for a listed contract that serves a significant price discovery function similar to the limits on DCMs.

3. **Self Regulatory Oversight** - An ECM should be required to monitor trading of a listed contract that serves a significant price discovery function to detect and prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.

4. **Emergency Authority** - The Commission and ECM should be provided with emergency authority to alter or supplement contract rules, liquidate open positions, and suspend or curtail trading in any listed contract that serves a significant price discovery function. These authorities would be essential tools for the Commission and an ECM to prevent manipulation and disruptions of the delivery or cash-settlement process.

The determination of whether an ECM contract serves a significant price discovery function should focus on the following factors: (1) *Material Liquidity* - trading volume in the ECM contract must be significant enough to affect regulated markets or to become a pricing benchmark; and (2) *Linkage/Material Price Reference* - the relevant ECM contract must either be influencing other markets and transactions through this linkage or be materially referenced by others in interstate commerce on a frequent and recurring basis.

In addition, to promote greater understanding of trading in energy futures products, the Commission intends to: (1) establish an Energy Markets Advisory Committee to conduct public meetings on issues affecting energy producers, distributors, market users and consumers; and (2) work closely with the Federal Energy Regulatory Commission (FERC) to educate and develop best practices for utilities and others who use NYMEX settlement prices as hedging vehicles and benchmarks in pricing their energy products.

II. Hearing Participants

CFTC Commissioners

- Walter L. Lukken – Acting Chairman
- Michael V. Dunn – Commissioner
- Jill E. Sommers – Commissioner
- Bartholomew H. Chilton – Commissioner

Panel I – CFTC Staff Witnesses

- Terry S. Arbit – General Counsel
- John F. Fenton – Deputy Director for Market Surveillance, Division of Market Oversight
- Jeffrey H. Harris – Chief Economist
- Richard A. Shilts – Director, Division of Market Oversight

Panel II – Trading Facilities

- Craig S. Donohue – Chief Executive Officer and Director, CME Group, Inc.
- Peter Krenkel – President, Natural Gas Exchange, Inc.
- James E. Newsome – President and Chief Executive Officer, New York Mercantile Exchange
- Richard L. Sandor – Chairman and Chief Executive Officer, Chicago Climate Exchange
- Jeffrey C. Sprecher – Chairman and Chief Executive Officer, InterContinental Exchange, Inc.

Panel III – Market Users

- Laura Campbell – Assistant Manager for Energy Resources, Memphis Light Gas & Water; Member, American Public Gas Association
- John M. Damgard – President, Futures Industry Association
- R. "Skip" Horvath – President, The Natural Gas Supply Association
- Russ Stolle – Senior Vice President, Global Public Affairs and Communication, Huntsman Corporation

Panel IV – Market Users

- Mark Cooper – Director of Research, Consumer Federation of America
- Sean Cota – President, Cota & Cota, Inc.; President, New England Fuel Institute; Northeast Chair, Petroleum Marketers Association of America
- John G. Gaine – President, Managed Funds Association
- Greg Zerzan – Counsel and Head of Global Public Policy, International Swaps and Derivatives Association, Inc.

III. Introduction

On September 18, 2007, the Commodity Futures Trading Commission (CFTC or Commission) held a hearing to examine the oversight of trading on regulated futures exchanges (DCMs) and exempt commercial markets (ECMs).[1] An ECM is a relatively new type of derivatives market that came into being by virtue of the provisions of the Commodity Futures Modernization Act of 2000 (CFMA). Although ECMs are subject to certain recordkeeping and reporting requirements, as well as the anti-fraud and anti-manipulation provisions of the Commodity Exchange Act (CEA or Act), they are not considered to be "regulated" markets.[2]

The Commission's review of trading on ECMs was prompted by several factors. One consideration was that nearly seven years have passed since adoption of the CFMA. Over this period, derivatives markets generally, and ECMs in particular, have continued to grow and evolve. Thus, the Commission determined that it was appropriate to review and evaluate how well the Act's ECM provisions are functioning and whether any adjustments may be needed. In addition, recent energy market volatility has raised questions regarding the role that trading on ECMs plays in these vital markets.[3] Concerns among lawmakers regarding energy markets have prompted a number of legislative proposals currently pending before Congress that would amend the Act's ECM provisions. In addition, the anticipated introduction of CFTC reauthorization legislation, which may also include amendments to the Act's ECM provisions, provides an opportunity for the Commission to weigh in on this important topic. As such, the Commission's review and report is intended to inform this debate in Congress.

Witnesses at the hearing included Commission staff, representatives of DCMs and ECMs, and representatives of a broad spectrum of market users and consumer groups. This report provides information regarding the relevant regulatory structure, reviews the testimony given at the hearing, and presents the Commission's findings and recommendations based on the hearing testimony and the Commission's expertise and experience administering the Act.

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[1] In lieu of attaching lengthy appendices to this report, the Commission has posted a transcript of the hearing, copies of the witnesses' written statements and exhibits, and other relevant background materials on its website at http://www.cftc.gov/newsroom/cftcevents/2007/event091807.html.

[2] *See* 7 U.S.C. § 2(h)(5)(F) (prohibiting ECMs from representing that they are registered with, designated, recognized, licensed, or approved by the Commission).

[3] *See e.g.*, The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat, Staff Report by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs, 109th Cong, 2nd Sess., June 27, 2007.

IV. Background

A. Statutory and Regulatory Requirements

1. Risk-Based, Multi-Tiered Approach to Regulation

The CFMA amended the Act to replace the historical "one-size-fits-all" supervisory framework for futures trading with a risk-based statutory structure in which the level of regulation is tailored to the type of market and the risks associated with that market. Based on recommendations from a report of the President's Working Group on Financial Markets (PWG)[4], the CFMA also provided much-needed legal certainty to the burgeoning over-the-counter (OTC) markets by creating statutory exclusions and exemptions from regulation for swaps and other OTC derivatives. The new framework was intended to create a regulatory environment that would promote continued growth and innovation in both the exchange and OTC derivatives markets and foster competition in a rapidly changing global marketplace.

Drawing from the Commission's "New Regulatory Framework," which was finalized just prior to the enactment of the CFMA[5], Congress codified in the CFMA a multi-tiered market framework in which the level of oversight applied is based primarily on the nature of the commodity being traded and the participants who are trading. In general, where access to a trading facility is restricted to more sophisticated traders or commercial participants, or where the type of commodity being traded poses a relatively low risk of susceptibility to manipulation, regulatory oversight is reduced to reflect the reduced need for supervision of that market. Markets with unrestricted commodity offerings open to all types of participants (DCMs) are subject to the highest level of regulatory oversight. 7 U.S.C. §§ 7, *et seq.*

The CFMA also created an exchange category called a derivatives transaction execution facility (DTEF). 7 U.S.C. §§ 7a, *et seq.* There are two types of DTEF – retail and commercial. DTEFs have fewer regulatory requirements than those for DCMs, but are subject to differing limitations on eligible traders and the commodities that may be traded. Although subject to a lighter regulatory regime than the DCM, the DTEFs must have compliance and surveillance programs, and must undertake significant self-regulatory responsibilities, including establishing and enforcing rules to deter trading abuses and monitoring the market to ensure orderly trading.[6]

A third market category created by the CFMA is the exempt board of trade (EBOT). 7 U.S.C. §§ 7a-3, *et seq.* Unlike DCMs and DTEFs, EBOTs are not registered with, or designated by, the Commission. EBOTs are exempt from most provisions of the CEA (other than its anti-fraud and anti-manipulation prohibitions), but are subject to certain commodity and participant restrictions.

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[4] *Over-the-Counter Derivatives Markets and the Commodity Exchange Act,* Report of the President's Working Group on Financial Markets, November 1999.

[5] *See A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations,* 65 Fed. Reg. 77962 (CFTC December 13, 2000) (adopting final rules); and 65 Fed. Reg. 82272 (CFTC December 28, 2000) (withdrawing final rules to determine their compatibility with the CFMA).

[6] To date, no trading facility has applied to the Commission to register as a DTEF.

Specifically, the commodities that can be traded on an EBOT are those defined as "excluded commodities," such as an interest rate, exchange rate, credit risk or measure, debt, measure of inflation or other macroeconomic index or measure. 7 U.S.C. § 1a(13). EBOTs must limit access to certain institutional and sophisticated persons defined as "eligible contract participants." 7 U.S.C. § 1a(12).[7]

In addition to creating three new market categories, the CFMA created several exclusions from regulation for certain swaps and other derivatives traded OTC on a bilateral basis.[8] These provisions reflected the view, consistent with the PWG report and various Congressional and Commission actions during the preceding decade, that off-exchange transactions for certain commodities between sophisticated counterparties do not necessarily require the full weight of the protections that the CEA provides for transactions executed on DCMs.[9]

Finally, the CFMA provided a separate exemption for transactions executed on ECMs under section 2(h) of the Act. 7 U.S.C. §§ 2(h)(3)-(5).[10] This exemption retains for the CFTC certain residual authorities over these transactions. To qualify for the ECM exemption, the transactions are required to be executed on electronic trading facilities on which multiple persons have the ability to trade contracts by accepting bids and offers from multiple other participants. The commodities eligible to be traded on an ECM are limited to "exempt commodities," which exclude agricultural and financial products but include primarily energy, metals, chemicals, and emission allowances. 7 U.S.C. § 1a(14). Under this exemption, ECMs must limit access to a

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[7] The term "eligible contract participant" (ECP) refers to institutional and highly accredited participants such as, among others, financial institutions, registered investment companies, corporations, partnerships, trusts, and individuals having total assets exceeding $10,000,000.

[8] For example, Section 2(g) created an exclusion from the CEA for swaps entered into between ECPs. 7 U.S.C. § 2(g). Similarly excluded are transactions between ECPs involving excluded commodities that are not executed on a trading facility. 7 U.S.C. § 2(d)(1). As pertains to energy commodities, where manipulation can be a concern, CEA Section 2(h)(1) provides that bilateral energy transactions entered into between certain defined commercial entities are exempt from the CEA, except for the CEA's anti-fraud and anti-manipulation prohibitions. 7 U.S.C. § 2(h)(1).

[9] *See e.g.*, *Policy Statement Concerning Swap Transactions,* 54 Fed. Reg. 30,694 (CFTC July 21, 1989) (stating that "at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the CEA…."); *Exemption for Certain Contracts Involving Energy Products*, 58 Fed. Reg. 21286 (CFTC April 20, 1993) (granting an exemption for certain contracts involving covered energy products entered into between commercial participants) ("Energy Exemption"). The Energy Exemption was part of a series of Commission orders issued pursuant to the Futures Trading Practices Act of 1992, which provided the Commission with explicit exemptive authority to be utilized as "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." H. Rep. No. 102-978, 102d Cong., 2d Sess. at 81 (1992).

[10] The current language of Section 2(h) initially passed the House of Representatives on October 19, 2000 by a vote of 377-4 (146 CR H10411, October 19, 2000) with a Statement of Administrative Policy in support of the legislation. This identical language was again passed as part of the CFMA in HR 4577 by both the House and the Senate on December 14 and 15, 2000, respectively (146 CR H2181, December 14, 2000 and 146 CR S11866, December 15, 2000).

subset of ECPs defined as "eligible commercial entities" (ECEs) that trade on their own behalf. 7 U.S.C. § 1a(11).[11]

Because ECMs are trading facilities where commercial and sophisticated entities, on a principal-to-principal basis, come together to trade commodities where manipulation can be a concern, they occupy their own niche in the risk-based, multi-tiered spectrum of regulation under the Act. As such, they are subject to greater regulatory requirements than EBOTs or bilateral OTC transactions, yet are not regulated to the same degree as DCMs or DTEFs.

2. Regulatory Requirements for ECMs

ECMs are subject to certain recordkeeping and reporting requirements under the CEA. For example, an ECM must maintain for five years, and make available for inspection upon request by the Commission, records of its activities related to its business as a trading facility. 7 U.S.C. § 2(h)(5)(B)(ii). More specifically, under Commission Rule 36.3, an ECM must identify to the Commission those transactions for which it intends to rely on the exemption in § 2(h)(3) of the Act and which averaged five trades per day or more over the most recent calendar quarter. For all such transactions, the ECM must provide to the Commission weekly reports showing certain basic trading information, or provide the Commission with electronic access that would allow the Commission to compile the same information. 17 C.F.R. § 36.3.

An ECM must also provide to the Commission, upon special call, any information relating to its business that the Commission determines is appropriate to enforce the anti-fraud and anti-manipulation provisions of the CEA, to evaluate a systemic market event, or to obtain information on behalf of another federal financial regulator. 7 U.S.C. § 2(h)(5)(B)(iii). Commission staff has issued several special calls to the InterContinental Exchange, an ECM generally referred to as "ICE" (discussed *infra,* section IV(D)(3)).

Finally, an ECM must also maintain a record of any allegations or complaints it receives concerning suspected fraud or manipulation, and provide the Commission with a copy of the record of each complaint that alleges facts that would constitute a violation of the CEA or Commission Regulations. 17 C.F.R. § 36.3.

3. Differences Between ECMs and DCMs

Though ECMs are subject to the foregoing regulatory requirements, the CEA does not subject them to the level of transparency and Commission oversight associated with DCMs. DCMs must satisfy specified criteria to become designated, and then must demonstrate compliance with core principles on a continuing basis. While the CEA provides flexibility in how DCMs choose to comply with the core principles, the core principles mandate that DCMs undertake significant supervisory responsibility with respect to trading on their markets. For example, DCMs may list for trading only those contracts that are not readily susceptible to manipulation and must have

[11] ECE refers to, among others, an entity that has a demonstrable ability to make or take delivery of an underlying commodity, incurs risks related to the commodity, or is a dealer that regularly provides risk management, hedging services, or market-making activities. ECEs can be funds, but cannot be individuals.

rules and procedures for preventing market manipulation. Further, DCMs are required to adopt position limit or accountability rules, where necessary and appropriate, in order to address the potential for market manipulation or congestion. DCMs also must have compliance and surveillance programs, which the Commission evaluates through its rule enforcement reviews.

These statutory requirements do not apply to ECMs. The CEA does not require ECMs to monitor trading on their markets. Nor does the CEA provide the Commission with emergency authority over ECMs in order to force a reduction or liquidation of positions, or alter or supplement trading rules. The Commission has this authority over DCMs.

The CEA gives the Commission the authority to determine whether an ECM contract performs a significant price discovery function for transactions in an underlying cash market. Such a determination, however, does not trigger any self-regulatory responsibilities for the ECM, or additional oversight authority for the Commission, akin to that existing for DCMs. The determination triggers only an obligation by the ECM to publicly disseminate certain specified information such as contract terms and conditions, trading volume, open interest, and opening and closing prices or price ranges. 7 U.S.C. § 2(h)(4)(D); 17 C.F.R. §36.3.

B. Evolution of ECMs Since 2000

The first ECMs that notified the Commission of their intent to operate generally were simple trading platforms, resembling in many ways business-to-business facilities for large commercial firms. Their key role was to facilitate the execution of trades between commercial counterparties by offering an anonymous and efficient electronic matching system believed to be superior to the existing voice broker system, and to provide for a competitive advantage in the bilateral OTC market, especially for energy products.

Initially, most ECMs were relatively small operations and their trading volumes were small compared to DCMs. The first ECMs did not offer a clearing component – they addressed issues related to the financial integrity of transactions by setting up credit filters that allowed traders to limit their counterparties to a customized list of traders. In addition, the contracts listed on early ECMs were not linked to contracts listed on DCMs and consequently did not affect the Commission's oversight of trading activity on DCMs.

Since 2001, 20 companies have notified the Commission that they intend to operate as ECMs. Many of these companies trade, or plan to trade, energy-related products – mostly natural gas, petroleum products and electricity. The first two facilities to file notices in 2001 were the International Maritime Exchange (Imarex), a Norwegian market, and ICE, located in Atlanta. Currently, eight of the 20 ECMs that filed a notice are active.

Based on CFTC staff interviews of market participants and on testimony given at the September 18 hearing, it appears that for many ECMs, the majority of their business comes from non-regulated institutional traders. Moreover, companies elect to become an ECM rather than a DCM or DTEF largely because of the reduced regulatory burden. ECMs view this reduced regulatory burden as being more amenable to their business operations and goals because becoming an ECM allows a market to expand into electronic trading under a less demanding

regulatory scheme. It also appears that markets have not used the ECM category as a stepping stone to eventually become a more regulated exchange, such as a DTEF or a DCM; ECMs have tended to remain ECMs.

During the last few years, there have been a number of changes in the ECM landscape. While some ECMs continue to be small, start-up type ventures, there are ECMs that have taken on some of the characteristics of DCMs. Significantly, five of the eight active ECMs now offer a clearing component that is widely utilized by their participants to obtain an efficient and effective means to manage credit risk.[12] There also have been changes in the types of traders that participate on ECMs, *i.e.*, certain exchange floor brokers and floor traders now are considered ECEs and are able to participate on ECMs subject to certain conditions.[13] Also, ECM trading communities now include many non-commercial traders, such as large hedge funds, which constitute a significant part of the overall activity and open interest in certain ECM contracts.

Although ECMs have been evolving over time to adopt some characteristics of DCMs, the linkage of ECM contract settlement prices to DCM futures contract settlement prices – a relatively recent development – has raised the question of whether the CFTC has the necessary authority to police these markets for manipulation and abuse. The linkage of contract settlement prices was not contemplated at the time of the CFMA nor at the time of the Commission's rulemaking concerning when an ECM contract performs a significant price discovery function. Of special concern to the CFTC staff today is the existence of ECM cash-settled "look-alike" contracts that could provide an incentive to manipulate the settlement price of the underlying DCM futures contract to benefit positions in the "look-alike" ECM contract.

C. Price Discovery on ICE

Utilizing these linked "look-alike" contracts, one ECM in particular, ICE, has become a major trading venue for natural gas in direct competition with the New York Mercantile Exchange (NYMEX) natural gas benchmark futures contract. Based on the comments of many traders and voice brokers, there appears to be an emerging consensus that ICE is a price discovery market for certain natural gas and electricity contracts. In addition, Commission staff has found that the traders on ICE are virtually the same as the traders on NYMEX. All of the top 25 natural gas traders on NYMEX are also significant traders on ICE. ICE's popularity seems to stem from a number of factors, including adequate liquidity and transparency in certain markets, ease of use, and flow-through processing whereby trades are automatically reflected in firms' balance sheets.

For the Henry Hub natural gas market, market participants generally view ICE and NYMEX as essentially a single market and look to both ICE and NYMEX when determining where to execute a trade at the best price. ICE offers a cash-settled contract based on the final settlement

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[12] Amending the law to allow clearing of OTC derivatives was one of the key recommendations made by the PWG Report in 1999.

[13] Among other things, a floor broker or floor trader seeking to qualify as an ECE must be a member of a DCM or have trading privileges on a DCM, and must either be an ECP or have its trades on the ECM guaranteed by a clearing member that is a member of a Commission-registered derivatives clearing organization and is an ECP. 68 FR 2319 (January 16, 2003).

price of the NYMEX Henry Hub physically-delivered contract. In addition, ICE lists a contract that cash-settles based on the final settlement price of the NYMEX Henry Hub natural gas contract on the penultimate day. Lastly, ICE offers a Henry Hub penultimate natural gas option contract. Traders use NYMEX physical and cash-settled contracts as well as ICE Henry Hub look-alike contracts depending on where they can get the best price for liquidity.

D. Economic Analysis of Price Discovery on NYMEX and ICE

The Commission's Office of the Chief Economist (OCE) conducted an empirical study of the relationship of the natural gas contracts that trade on ICE and NYMEX. OCE evaluated price discovery in the natural gas market, viewing price discovery as the process by which new information is incorporated into prices.

When conducting economic analysis of price discovery, a determination that informed traders prefer to trade at one venue over another implies the preferred venue is a price discovery venue. It follows that if venue A is preferred, then price changes there will more likely reflect new information and those changes at venue A should precede changes at venue B. This insight implies that price leadership - that is, a statistical pattern whereby price changes at one exchange precede changes at another exchange - can be interpreted as revealing where price discovery is occurring. Since price leadership can shift between exchanges, it is possible to find that both venues are, at various times, price discovery venues.

Turning to its specific price discovery analysis, OCE collected transaction prices for ICE and NYMEX natural gas contracts from January 3, 2006 through December 31, 2006 and evaluated trading for 20 contract months when trading on each market was appropriately active. OCE examined the timing of price changes on ICE and NYMEX to draw inferences about where information arrives first. If price changes on one venue consistently "led" those on the other venue, then OCE concluded that informed traders preferred trading at that "leading" venue and inferred that market to be "discovering" prices. OCE found that ICE exhibited price leadership with respect to NYMEX on 20 percent of the contract-days, with NYMEX exhibiting price leadership on 63 percent of the contract-days. OCE concluded that these results suggest that, in an economic sense, ICE and NYMEX are both significant price discovery venues for natural gas futures contracts.

As part of OCE's broad analysis of price discovery, OCE first analyzed the mix of hedgers and speculators trading in various markets. The OCE analysis shows that from July 2004 through July 2007 (a period that experienced significant growth in ICE natural gas trading) non-commercial trading (trading by swap dealers and managed money traders) of natural gas futures on NYMEX grew from 42 percent to 52 percent. OCE then compiled similar statistics for active contracts that face minimal ECM competition (corn, heating oil and crude oil). OCE found that the increase in market share by non-commercial traders in natural gas on NYMEX is broadly consistent with similar increases in market share by non-commercial traders in the corn, heating oil and crude oil markets facing minimal ECM competition. Non-commercial trading interest has risen across the board, with both managed money traders and non-reportable trades driving this increase in all markets. In this light, the changing composition of traders in NYMEX natural gas futures trading from 2004-2007 largely represents a market-wide trend toward greater non-

commercial trading. As such, OCE concluded that the existence and growth in trading of ICE natural gas contracts does not appear to be a factor in the changing composition of traders in the broader natural gas market.

E. ECMs and Market Surveillance

1. Focus of Commission Surveillance of Energy Markets

The Commission's surveillance of natural gas energy markets focuses on the regulated futures markets at NYMEX. This approach reflects the mandate of the CEA, as DCM contracts are subject to both the CEA reporting requirements that underlie the Commission's large trader reporting system (LTRS) and the statutory provision that enables the Commission to take emergency actions in the case of "threatened or actual market manipulations and corners."[14] By comparison, while natural gas transactions on ECMs are subject to the CEA's anti-manipulation prohibition, they are not subject to these reporting and emergency action provisions. As a result of this disparity, the CFTC surveillance staff finds it increasingly difficult to properly police the regulated markets at NYMEX. To accomplish appropriate surveillance levels, Commission staff needs further transparency into the trading activity on ICE for those contracts linked to NYMEX contracts.

2. Information Received From DCMs

The centerpiece of the Commission's market surveillance program is its LTRS. Under the LTRS, clearing members, futures commission merchants (FCMs), and foreign brokers – collectively called "reporting firms" – file daily reports with the CFTC showing futures and option positions held in accounts they carry that are at or above specific reporting levels set by the CFTC. These reporting levels vary by market, from as low as 25 contracts for small markets to as high as 3,000 contracts. The reporting level for NYMEX natural gas futures markets is 200 contracts. The data provided in these reports in aggregate has covered about 97 percent of total open interest in the NYMEX Henry Hub natural gas contract during the past year.

DCMs are required to provide daily data showing aggregate positions and trading cleared by each clearing member, shown separately for house and individual customer positions. These data include all positions in futures markets at the DCM, but do not reflect the size or identity of customer positions. The Commission also receives large-trader reporting for contracts that are cleared through NYMEX's Clearport facility. Typically, these transactions are executed in the OTC market, through voice brokers, and are then submitted to Clearport for clearing.

In addition, the Commission receives from all DCMs, including NYMEX, daily transaction data, which provide a complete audit trail of all trades that occur in DCM markets. Surveillance staff uses this data to scrutinize trading activity during key trading periods, especially during the closing range of the final trading day.

[14] 7 U.S. C. § 12(a)(9).

Staff from the Commission's Division of Clearing and Intermediary Oversight also uses this trading data to monitor the financial integrity of futures firms and the clearing system to ensure that trading losses do not trigger defaults that may lead to a contagion event in the markets.

3. Special Calls to ICE

In order to obtain analogous trader information from ECMs, the Commission must issue special calls. To date, the Commission has issued three special calls to ICE for information related to ICE's cleared natural gas swap contracts that are cash-settled based on the settlement price of the NYMEX physical delivery natural gas contract. The special calls were issued primarily to assist the Commission in its surveillance of the NYMEX natural gas contract. They were not issued as part of an investigation of any particular market participant or trading activity on either ICE or NYMEX, nor were they issued to conduct regular market surveillance of ICE.

A special call issued on September 28, 2006 requested daily clearing member position data for ICE's natural gas swap contracts, broken out between house and aggregate customer positions, which is similar to information that the Commission receives from NYMEX. The Commission has been receiving responsive data from ICE since October 10, 2006. With this data, market surveillance staff can see all cleared positions at the clearing member level, but it is not possible to determine individual customer positions.

To obtain daily individual trader positions, the Commission issued a further special call on December 1, 2006 and has been receiving responsive data since February 15, 2007. While the data received is similar to large trader reporting for DCMs, the methodology for reporting is very different. As noted above, large trader reporting for products traded on DCMs is done by the carrying firms, generally FCMs for U.S. traders, and foreign brokers for non-U.S. traders. Since the reporting firms have exact data regarding customer positions, this reporting is fairly straight-forward and highly accurate. ICE, however, is a non-intermediated market and therefore does not receive position reporting from firms. Therefore, in order to comply with the special call, ICE developed an algorithm to infer open positions from the sum of all trading by each individual trader. While this approach is innovative and has provided valuable information, it is not as accurate as traditional large trader reporting. ICE is providing information responsive to these first two special calls in the standard electronic format used for Commission large trader reporting, which allows staff quickly to integrate this data into its computer surveillance systems and to examine traders' consolidated positions on NYMEX and ICE.[15]

The most recent special call to ICE was issued on September 5, 2007 and requires ICE to provide all cleared transaction data for its Henry Hub swap contracts and identify counterparties for the final two trading sessions prior to the expiration of prompt month Henry Hub natural gas products. This data is similar to transaction data that the Commission receives from NYMEX for all trading days. When the Commission begins to receive this data, staff will be able to monitor trading activity on ICE during these crucial last two days, in conjunction with its analysis of

[15] The CFTC is receiving all trade data regarding the relevant ICE contracts, while DCMs provide data for only large traders. Overall, the data the CFTC currently receives typically covers roughly 80 to 90 percent of the affected market.

NYMEX trading, to provide more complete coverage to counter possible manipulative schemes that could impact trading on NYMEX.

V. The Commission's ECM Hearing

The Commission's hearing focused on a number of issues, including the tiered regulatory approach of the CFMA and whether this risk-based model is beneficial; the similarities and differences between ECMs and DCMs; the associated regulatory risks of each market category; the types of regulatory or legislative changes that may be appropriate to address identified risks; and the impact that regulatory or legislative changes might have on the U.S. futures industry and the global competitiveness of the U.S. financial industry. The hearing focused largely on energy markets and trading of energy products on ECMs and DCMs.

Many of the witnesses discussed the benefits of competition, innovation, and enhanced market transparency. Generally, the majority view was that some revisions to the ECM provisions may be appropriate, as long as the revisions are prudently targeted and do not adversely affect the ability of established ECMs and start-up ECMs to innovate and potentially to grow into mature markets.

While many witnesses testified that the tiered regulatory structure of the CFMA was successful and should not be eliminated, witnesses also described concerns associated with the current regulatory structure governing ECMs and the regulatory disparity between DCMs and ECMs. These concerns included competitiveness concerns that DCMs operate under more stringent regulatory requirements and responsibilities than ECMs, concerns that energy trading on ECMs contributes to price volatility, and concerns that some market participants and consumers have lost confidence in the integrity of the energy markets.

Addressing price volatility and consumer confidence, Laura Campbell, testifying both on behalf of Memphis Light Gas and Water and the American Public Gas Association (APGA), stated that "APGA's members have lost confidence that the prices for natural gas [in] the futures [and] economically linked over-the-counter markets are accurate reflections of supply and demand" (Campbell at 172). Mark Cooper, representing the Consumer Federation of America, noted that "the lack of regulation of trading . . . has influenced the price of natural gas in a volatile and upward direction" (Cooper at 218). Further, Sean Cota, representing the Petroleum Marketers Association of America, described energy price volatility as a "rollercoaster ride" for consumers and energy traders with the consumer ultimately paying the price (Cota at 239).

Addressing competition and innovation, Dr. James Newsome, President of NYMEX, testified that the current structure has led to innovations and technology advancements that forced NYMEX to change to become more competitive (Newsome at 111). From the market user perspective, Ms. Campbell testified that the ability to view trading at ICE on a daily basis has fundamentally changed the way her company purchases gas and that she would be hesitant to lose the benefits her company has experienced as a result (Campbell at 201). Nevertheless, Ms. Cambpell did suggest that the current law needs to be changed to provide the Commission with the tools "to detect and deter potential manipulative activity before [APGA] members and their customers suffer harm" (Id. at 174).

Peter Krenkel, President of the Natural Gas Exchange (NGX) testified that for NGX "innovation is the key" and that it is critical that regulatory changes not impair the ability to innovate

(Krenkel at 116). Along those same lines, Richard Sandor, Chairman and Chief Executive Officer of the Chicago Climate Exchange, credited the current regulatory structure with providing the ability to operate as an ECM without undue cost and with speed to market for new contracts that helped him form a new exchange (Sandor at 108). In his view, the legal costs of trying to develop innovative products under a highly regulated structure would "limit creativity" (Id. at 115). Similarly, John Damgard, President of the Futures Industry Association, testified that ECMs provide incubation periods for new kinds of trading and new kinds of markets (Damgard at 203). Greg Zerzan of the International Swaps and Derivatives Association recognized this incubation period and the resulting innovation as providing a social benefit that contributes to the United States economy (Zerzan at 242).

There was little support for the option of simply deleting §§ 2(h)(3)-(5) from the Act.[16] The witnesses who addressed this issue generally took the view that increased regulatory oversight might be appropriate for certain contracts traded on ECMs, such as contracts that are "highly linked and functionally equivalent [to] regulated DCM contracts" (Newsome at 87). Even Jeffrey Sprecher, Chairman and Chief Executive Officer of ICE, acknowledged that for certain ICE contracts that are "the economic equivalent of actively-traded futures contracts," a "heightened level of DCM-like regulation … may be appropriate" (Sprecher at 91). However, with respect to other ECM contracts having no nexus to DCM contracts, there was widespread support for retaining §§ 2(h)(3)-(5) in some form.

Dr. Newsome testified that NYMEX does not believe that the case has been made for broadly extending regulation to ECM products that have not triggered "policy interests and concerns" (Newsome at 87). Along those lines, he testified that Congress should move forward with general criteria that capture the natural gas market as it currently exists and if other markets develop similarly, the CFTC should have the flexibility then to capture those markets as well (Newsome at 120). Mr. Krenkel agreed and supported the idea of flexible regulations able to accommodate different types of trade execution facilities given that from NGX's perspective "the ECM regulatory framework has been successful" (Krenkel at 104). By way of example, Mr. Sprecher testified that while ICE's one natural gas "look-alike" contract has gotten much attention, ICE trades 1,000 products on its platform, including lightly traded "exotic derivatives" and "niche products" that would not benefit from regulation as a DCM (Sprecher at 114).

Witnesses supportive of the tiered regulatory approach of the CFMA recognized that the evolution of trading on ECMs deserves a close review by the Commission, particularly in markets where greater market transparency is necessary. Skip Horvath, President of the Natural Gas Supply Association, testified representing producers and marketers of natural gas. He attributed price volatility to the fact that supplies are "artificially constrained" due to gas-prone lands that are off limits, not to problems with the current regulatory system (Horvath at 169). He noted, however, that the current system can be improved, but should be done so prudently (Id. at 170). Mr. Damgard testified that when trading occurs on multiple trading facilities, such as energy products on NYMEX and ICE, it is important that CFTC market surveillance has ready

[16] Only Craig Donahue, representing the CME Group, suggested that "the elimination of the [§ 2(h)(3)] exemption for unregulated commercial markets must be seriously considered (Donahue at 95-6). He argued that the case had not been made that eliminating the ECM category would impair innovation since "innovation can certainly occur in the context of a DTEF or . . . a DCM" (Id. at 112).

access to all relevant large trader information (Damgard at 181). Similarly, John Gaine, President of the Managed Funds Association (MFA), testified that MFA supports the CFTC and others "obtain[ing] access to all relevant surveillance data" (Gaine at 233).

While witnesses advocated some targeted changes, there did not appear to be a widespread call for further regulating the voice-broker or bilateral OTC markets due to the lack of price discovery occurring on these markets and the ability of the Commission to receive certain cleared pricing data and other information regarding these transactions from market participants on a case-by-case basis.

VI. Findings and Recommendations

A. Commission Findings

Based upon the ECM hearing, staff interviews of industry participants, and its general experience administering the CEA, the Commission believes that the CFMA's tiered approach to the regulation of OTC and exchange markets has operated well. The scaling of regulation based upon the financial accreditation and sophistication of transaction parties, the type of commodity underlying the transaction, and the method by which the transaction is undertaken has alleviated much of the legal uncertainty that surrounded derivatives trading before the CFMA. This structure sensibly ensures an appropriate degree of oversight for markets that serve a public interest due to their risk management and price discovery capabilities. It is also important to note that other jurisdictions around the world are adopting a similar tiered regulatory approach to compete with our markets as evidenced by the European Union's implementation of the Markets in Financial Instruments Directive (MiFID).[17]

Of the classes of markets created by the CFMA, the ECM category has proven to be particularly popular for new start-up markets, with the Commission issuing 20 acknowledgement letters to new ECMs since 2000. As was pointed out at the ECM hearing, new markets face regulatory hurdles to achieve and maintain DCM status, notwithstanding the CFMA's establishment of a flexible, principles-based regulatory scheme for DCMs. By comparison, ECMs are largely unregulated with only residual authorities reserved for the Commission. For example, although ECMs are required to retain basic records, to submit limited transaction data to the Commission for higher-volume contracts and to forward participant complaints to the Commission, they have no self-regulatory obligations with respect to trading on their facilities. Similarly, while ECM transactions are subject to the CEA's anti-manipulation and anti-fraud provisions[18], ECMs and ECM participants are not subject to the same type of ongoing Commission oversight measures that the Commission uses to deter and detect manipulation and fraud on DCMs.

The lower level of regulation for ECMs has made that category an ideal platform for markets seeking a low-cost, effective "on-ramp" to launch new ideas for contract design and trading methodologies. As a result, ECMs can serve as incubators for new concepts to see if they take hold in the marketplace. ECMs also can provide competition for DCMs, spurring established DCMs to respond to ECM initiatives with innovations of their own, whether it be developing new products or accelerating their pace of automation.

The Commission believes that the CEA's current level of regulation is appropriate for ECM contracts relying on the § 2(h)(3) exemption when trading volume remains low and their prices are not significantly relied upon by other markets. However, the Commission also believes that

[17] On October 2, 2007, the CFTC's Global Markets Advisory Committee heard testimony from EU officials regarding the implementation of MiFID and the tiered regulatory categories that are being adopted as part of that effort.

[18] The Commission continues to support amending CEA Section 4b, 7 U.S.C. § 6b, to clarify the Commission's authority to bring fraud actions involving principal-to-principal transactions that occur on ECMs. In the last Congress, such an amendment was included in reauthorization legislation reported by the Senate Committee on Agriculture, Nutrition and Forestry, and in reauthorization legislation passed by the House of Representatives.

when such an ECM contract matures and begins to serve a significant price discovery function for cash or futures market transactions in commodities in interstate commerce, the contract warrants some increased regulatory oversight in order to effectuate the CEA's mandate that the Commission "deter and prevent price manipulation or any other disruptions to market integrity." 7 U.S.C. § 5. Without some increased oversight of trading in relevant mature ECM contracts, the Commission cannot adequately police the trading of DCM contracts to detect and deter price manipulation and other trading abuses.

Beyond addressing these supervisory risks, the current regulatory disparities between ECMs and DCMs also create competitive concerns that may unfairly advantage ECMs due to the restrictions and responsibilities placed on DCMs that do not also apply to ECMs. These competitive concerns arise in the cost to a DCM of complying with its self-regulatory obligations, and more acutely, in the ability of ECMs to allow traders to trade without limit, while DCMs must impose position limits or accountability levels on their traders. Given the Commission's duty to uphold "fair competition"[19] among markets, this is an important consideration in the debate.

The Commission believes that there is a strong public interest in ensuring the integrity of the market for any futures contract that performs a significant price discovery function. Prices that are established by transactions in a contract that serves as a significant price discovery vehicle can affect the prices of commercial transactions and ultimately retail prices for the commodity underlying the contract. It was, of course, the interests of those who use futures markets for price discovery purposes that led Congress to establish a regulatory regime to protect the public interest in the commerce affected by these markets.[20] While the Commission currently has the authority to bring manipulation cases involving ECM transactions, that authority necessarily can only be used after the fact. The Commission has few regulatory tools available to prevent such market abuses from occurring in ECM contracts and to detect them when they occur.

The Commission notes that ECM participation is limited to eligible commercial entities – a fairly sophisticated group of market participants trading on their own behalf. Notwithstanding this limitation, the Commission believes that any significant price discovery function performed by an ECM contract requires a heightened level of oversight. Limiting ECM participation to sophisticated traders does not eliminate the possibility that the exempt commodity contracts traded on an ECM can be manipulated.[21] Further, even if ECM participants do not require the

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[19] 7 U.S.C. § 5.

[20] The *Congressional Record* is replete with discussion of the commercial importance of commodity futures trading. The record recognizes that commercial interests must be able to look to properly functioning commodity markets for market information and products that facilitate the making of marketing, financing and distribution decisions. S. Rep. No. 93-1131, at 12 (1974). The *Congressional Record* also indicates that an initial purpose behind regulating commodity futures trading was to secure fair and orderly markets for producers, and later other commercial participants, who use the markets for price basing and hedging. Hearings on S. 2485, S. 2578, S. 2837 and H.R. 1311 before the Senate Committee on Agriculture and Forestry, 93rd Cong., 2d Sess. at 234; *see also* 80 Cong. Rec. 10739 (April 11, 1974).

[21] Congress recognized this as well when it imposed an anti-manipulation prohibition on ECM transactions. By contrast, under section 2(d)(2) of the Act, Congress did not impose an anti-manipulation prohibition on trading facilities that limit trading to eligible contract participants trading excluded commodities such as financials.

type of customer safeguards typically associated with DCM trading, it does not obviate the public interest in protecting the significant price discovery function performed by an ECM contract. Accordingly, the Commission believes that ECM contracts that become significant sources of price discovery should be subject to a higher level of regulation than is now the case under §§ 2(h)(3)-(5) and the Commission's Regulations thereunder.

It is also important to note that the CFTC hearing, staff interviews, and staff experience in surveillance of these markets do not suggest that the OTC bilateral or voice broker energy markets exhibit significant price discovery attributes. Thus, their direct impact on other parties and markets is limited. In addition, the non-standardized form and significant size and dispersion of these markets would make it extremely costly and difficult to extrapolate beneficial market surveillance information on a routine basis.

B. Commission's Legislative Recommendations

In light of its findings, the Commission recommends the following legislative changes[22] in order to detect and prevent manipulation and to ensure the market integrity of ECM contracts that perform a significant price discovery function for commodities in interstate commerce.[23]

In formulating these recommendations, the Commission has attempted to balance the public interest in allowing ECMs the opportunity to innovate and grow with the public interest in sufficient oversight over the trading on ECMs of contracts that serve a significant price discovery function for commodities in interstate commerce. The Commission's recommendations represent a careful, measured approach to detect and prevent price manipulation and disruptions to market integrity, to ensure fair competition among markets, and to continue to promote the significant innovation brought about by ECMs since the CFMA was enacted.

The Commission's recommendations are contract specific and do not necessarily affect the entirety of an ECM's platform since ECMs host a broad range of products and contracts that may not serve a significant price discovery function. Furthermore, these recommendations apply to all exempt commodities – not just energy – given the concern that any of these exempt products may be susceptible to manipulation once they begin to serve a significant price discovery role.

Once a determination is made that certain ECM contracts serve a significant price discovery function, the new regulatory status of those ECM contracts should be principles-based and should be within the Commission's exclusive jurisdiction. Moreover, by virtue of being within this new regulatory status, the contract will benefit from the Commission's regulatory passport

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[22] The Commission also recommends that Congress should provide the Commission with adequate rulemaking authority in connection with each of the CEA amendments recommended herein so it has the ability to properly implement the provisions.

[23] For the purposes of this report, the Commission has set forth its suggested statutory revisions in broad terms, rather than proposing specific amendatory language. The Commission stresses its willingness to assist Congress and Congressional staff in drafting any CEA revisions implementing these recommendations or regarding any other matter.

regarding trading the contract by market participants located in other jurisdictions around the world.

Authorities Requested

With this in mind, the Commission recommends amendments to the CEA that grant certain authorities to the Commission over ECM contracts that serve a significant price discovery function and certain self-regulatory responsibilities to ECMs over those contracts:

1. Large Trader Position Reporting – An ECM contract that is determined to serve a significant price discovery function should be subject to large trader position reporting requirements comparable to those that currently apply to all DCM contracts. A large trader reporting system would enable the Commission's market surveillance staff to monitor positions on a daily basis to detect and deter possible manipulative schemes. The statutory basis for the Commission regulations that establish a large trader reporting system, Section 4i of the CEA, 7 U.S.C. § 6i, should be amended to apply to an ECM contract that serves a significant price discovery function. That authority over certain ECM contracts would enable the Commission to require position reporting by individual traders and clearing members and to issue special calls to these traders and firms, as needed, for related position data as the Commission currently does for DCM contracts.

2. Position Limits and/or Accountability Level Regime – An ECM should be required to adopt position limits or accountability levels, as appropriate, for a listed contract that serves a significant price discovery function. For cash-settled ECM contracts, such levels ideally would reflect trading activity in the underlying market at the time when the cash settlement price is determined. For any cash-settled ECM contract that is based on a DCM contract's final settlement price, the ECM should establish an agreement with the DCM for obtaining trading volume data during the DCM's final settlement period. For physically-delivered contracts, such levels must reflect deliverable supply. To ensure the Commission's ability to monitor compliance with this obligation, the ECM would be required to provide to the Commission any rules relating to contract terms/conditions and establishing position limits or accountability levels, notify the Commission of any amendments to these rules, and provide any information requested by the Commission when it evaluates the ECM's requirements and procedures.

3. Self Regulatory Oversight – An ECM should be required to monitor trading of a listed contract that serves a significant price discovery function to detect and prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process. As part of this monitoring, an ECM should collect market data and trading information and provide such information, upon request, to the Commission.

4. Emergency Authority – The CEA should be amended to require an ECM to adopt rules to provide for the exercise of emergency authority to alter or supplement contract rules, liquidate open positions, and to suspend or curtail trading in any listed contract that serves a significant price discovery function. The Commission should be granted similar emergency authority relative to these price discovery contracts (authority the Commission has relative to

DCMs). These authorities for an ECM and the Commission would be essential tools to prevent manipulation and disruptions of the delivery or cash-settlement process.

It is the Commission's belief that, for ECM contracts that serve a significant price discovery function, these additional authorities and responsibilities are measured and appropriate and will ensure fairness by conferring responsibilities on ECMs consistent with those applicable to DCMs in Core Principles 3, 4, 5, and 12. *See* 7 U.S.C. §§ 7(d)(3), (4), (5), and (12).

In light of the legislative changes proposed, the Commission must also revisit its rulemaking that requires the reporting of a product's volume and prices if it serves a significant price discovery function so that the rulemaking can reflect the legislative changes recommended herein.

Significant Price Discovery Standard

A determination of whether an ECM contract serves as a significant source of price discovery should: (1) include measures that are quantifiable and verifiable to ensure decision making is simplified and transparent; (2) seek to minimize the costs of administration imposed on the Commission and the costs of compliance imposed upon the ECMs; and (3) recognize that start-up ECMs and new contracts will generally not have sufficient liquidity to serve as a significant source of price discovery.

Consistent with these general principles, the Commission believes Congress should instruct the Commission to use the following factors in determining whether a contract serves a significant price discovery function:

Material Liquidity: The volume of trading of the relevant contract must be high enough to be able to impact other regulated contracts or to become an independent price reference or benchmark that is regularly utilized by the public. In this context, consideration should be given to the size of the relative market of the underlying commodity and the susceptibility of these markets to manipulation; and

Linkage/Material Price Referencing: The linkage of ECM pricing to the settlement terms of a regulated contract on a DCM is an indication of significant price discovery since this allows for easier substitution of products between the linked markets. Material price referencing of ECM contracts also can indicate that significant price discovery is occurring when prices of ECM contracts are referenced in setting the price in other transactions in commodities in interstate commerce on a frequent and recurring basis.[24]

C. Other Recommendations

In addition to the legislative amendments recommended above, the Commission intends to undertake two initiatives to promote greater understanding of trading in energy futures products.

[24] Although not a factor directly relating to price discovery, clearing of products may indicate that a product is more standardized and mature, and more likely to be linked or serve as a material price reference for transactions in commodities in interstate commerce.

The Commission plans to establish an Energy Markets Advisory Committee to conduct public meetings on issues affecting energy producers, distributors, market users and consumers, as well as others interested in or affected by energy futures markets. The Commission believes that an Energy Markets Advisory Committee will facilitate regular communications between the Commission and the diverse energy-related interests affected by these markets.

The Commission proposes to work closely with the Federal Energy Regulatory Commission (FERC) to educate and develop best practices for utilities and others who use NYMEX settlement prices as benchmarks in pricing their energy products. These efforts would focus on ensuring that these organizations fully understand the mechanics of the settlement processes at NYMEX and on working with these organizations and NYMEX to develop different benchmarking approaches if appropriate. The CFTC and FERC should also help educate these end users of energy on how to utilize the futures and other derivatives markets in managing price risk and volatility.

The CHAIRMAN. Thank you, sir.

Before we move on I would ask unanimous consent of the Members that Mr. Barrow may sit with this Committee today. Without objection.

Ms. Williams.

STATEMENT OF ORICE M. WILLIAMS, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, D.C.

Ms. WILLIAMS. Mr. Chairman, Ranking Member and Members of the Subcommittee, I am pleased to be here today to discuss our recently issued report on the trading of derivatives for energy commodities, and the scope of CFTC's authority and oversight.

As you well know, recent increases in energy prices have raised questions about the reasons for the increase and the scope of CFTC's authority over certain markets. Our work revealed that both derivatives energy markets and physical commodities markets have undergone substantial change and growth. For example, trading volume both on and off-exchange has grown tremendously as new traders have been attracted to these markets in search of higher returns. However, this growth in off-exchange trading has also resulted in questions about the scope of CFTC's authority over these markets, particularly certain exempt commercial markets which are subject to less regulation and oversight than regulated exchanges.

Our report addresses certain questions about trends and changes in the market and the scope of CFTC's authority in enforcement activities in energy markets. Briefly, I would like to highlight a few of our findings and recommendations.

Energy products are traded on futures exchanges, exempt commercial markets and over-the-counter or OTC markets. By design, each market is subject to varying levels of CFTC oversight with some markets largely unregulated. As you know, under the Commodity Exchange Act CFTC regulatory oversight is focused on surveillance of futures exchanges to protect the public and ensure the integrity of the market. Conversely, both the exempt commercial market and the OTC market are exempt from general CFTC oversight. However, both markets are subject to CFTC's enforcement of the CEA's anti-manipulation, and where applicable, antifraud provisions.

This tiered structure results in CFTC having varied access to trading information depending on the market. That is, for regulated exchanges CFTC receives daily trading information. For exempt commercial markets, CFTC has authority to request information as needed, and for bilateral contracts, CFTC routinely receives no information. Changes in some markets, notably the natural gas market, have raised questions about whether the oversight of certain markets is sufficient.

While the report recommends that Congress continue to consider the scope of CFTC's authority as part of the reauthorization process, we also made a number of recommendations to CFTC to help improve its operations, including improving the transparency of certain trader reporting information, better documenting its surveillance activities, and developing more meaningful performance-

based measures for its enforcement program. And we commend CFTC for taking steps to address these recommendations.

However, the larger policy issues are much more complicated to solve and require ongoing debate and study. Therefore, as this Subcommittee and others in Congress continue to explore and debate policy alternatives for the scope of CFTC's authority, additional information is needed to understand what may need to be done to best protect investors from fraudulent, manipulative and abusive practices.

Such questions include: How different or more similar are the characteristics and uses of exchange and off-exchange products being traded, and are the differences still justified? To what extent does trading off-exchange effect price discovery and what are the regulatory implications? How much of an impact are non-traditional market participants, such as commodity index funds having on these markets? And finally, are energy markets unique or are these issues also relevant to other commodities markets, and if so how do you ensure equitable treatment? By answering these questions, information would be available to assess which, if any, changes should be made to CFTC's tiered oversight structure.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions that you or other Members of the Subcommittee may have. Thank you.

[The prepared statement of Ms. Williams follows:]

PREPARED STATEMENT OF ORICE M. WILLIAMS, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, D.C.

Commodity Futures Trading Commission

Trends in Energy Derivatives Markets Raise Questions About CFTC's Oversight

Why GAO Did This Study

Energy prices for crude oil, heating oil, unleaded gasoline, and natural gas have risen substantially since 2002, generating questions about the role derivatives markets have played and the scope of the Commodity Futures Trading Commission's (CFTC) authority. This testimony focuses on (1) trends and patterns in the futures and physical energy markets and their effects on energy prices, (2) the scope of CFTC's regulatory authority, and (3) the effectiveness of CFTC's monitoring and detection of abuses in energy markets. The testimony is based on the GAO report, *Commodity Futures Trading Commission: Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight* (GAO–08–25, October 19, 2007). For this work, GAO analyzed futures and large trader data and interviewed market participants, experts, and officials at six Federal agencies.

What GAO Recommends

As part of CFTC's reauthorization process, GAO recommended that Congress consider exploring the scope of the agency's authority over energy derivatives trading, in particular for trading in exempt commercial markets. In addition, GAO recommends that CFTC improve the usefulness of the information provided to the public, better document its monitoring activities, and develop more outcome-oriented performance measures for its enforcement program. CFTC generally agreed with GAO's recommendations.

To view the full product, including the scope and methodology, click on GAO–08–174T. For more information, contact Orice Williams at (202) 512–8678 or *williamso@gao.gov*.

What GAO Found

Various trends in both the physical and futures markets have affected energy prices. Specifically, tight supply and rising demand in the physical markets contributed to higher prices as global demand for oil has risen rapidly while spare produc-

tion capacity has fallen since 2002. Moreover, increased political instability in some of the major oil-producing countries has threatened the supply of oil. During this period, increasing numbers of noncommercial participants became active in the futures markets (including hedge funds) and the volume of energy futures contracts traded also increased. Simultaneously, the volume of energy derivatives traded outside of traditional futures exchanges increased significantly. Because these developments took place concurrently, the effect of any individual trend or factor on energy prices is unclear.

Under the authority granted by the Commodity Exchange Act (CEA), CFTC focuses its oversight primarily on the operations of traditional futures exchanges, such as the New York Mercantile Exchange, Inc. (NYMEX), where energy futures are traded. Increasing amounts of energy derivatives trading also occur on markets that are largely exempt from CFTC oversight. For example, exempt commercial markets conduct trading on electronic facilities between large, sophisticated participants. In addition, considerable trading occurs in over-the-counter (OTC) markets in which eligible parties enter into contracts directly, without using an exchange. While CFTC can act to enforce the CEA's antimanipulation and antifraud provisions for activities that occur in exempt commercial and OTC markets, some market observers question whether CFTC needs broader authority to more routinely oversee these markets. CFTC is currently examining the effects of trading in the regulated and exempt energy markets on price discovery and the scope of its authority over these markets—an issue that will warrant further examination as part of the CFTC reauthorization process.

CFTC conducts daily surveillance of trading on NYMEX that is designed to detect and deter fraudulent or abusive trading practices involving energy futures contracts. To detect abusive practices, such as potential manipulation, CFTC uses various information sources and relies heavily on trading activity data for large market participants. Using this information, CFTC staff may pursue alleged abuse or manipulation. However, because the agency does not maintain complete records of all such allegations, determining the usefulness and extent of these activities is difficult. In addition, CFTC's performance measures for its enforcement program do not fully reflect the program's goals and purposes, which could be addressed by developing additional outcome-based performance measures that more fully reflect progress in meeting the program's overall goals. Because of changes and innovations in the market, the reports that CFTC receives on market activities may no longer be accurate because they use categories that do not adequately separate trading being done for different reasons by various market participants.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our recent report on the trading of derivatives for energy commodities, including crude oil and natural gas, and the Commodity Futures Trading Commission's (CFTC) oversight of these markets.[1] The expansion of derivatives trading in energy markets, particularly by participants such as hedge funds, and rapid growth in trading off regulated exchanges have raised questions about the quality and quantity of reporting on and oversight of these trading activities.[2]

Specifically, I will discuss (1) trends in the physical and energy derivatives markets and their effect on energy prices, (2) the scope of CFTC's authority for protecting market users in the trading of energy derivatives, and (3) CFTC's monitoring and detection of market abuses in energy futures markets. I should point out that our review was intended to identify trends in both the physical and derivatives energy markets and to provide information on the current regulatory structure for energy derivatives trading, including analyzing the various perspectives of market participants on these issues. While our report frames issues that need to be addressed, we do not offer specific policy solutions.

During the course of our review, we obtained and analyzed energy futures prices and trading volumes from the New York Mercantile Exchange, Inc. (NYMEX). Specifically, we collected data for crude oil, heating oil, natural gas, and unleaded gas from January 2002 through December 2006. We also analyzed data obtained from CFTC on market participants and the outstanding trading positions of different categories of traders. We reviewed publicly available information, including academic studies and reports and market data. Finally, we interviewed a broad range of market participants and observers, representatives of energy trading markets, and gov-

[1] GAO, *Commodity Futures Trading Commission: Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight*, GAO–08–25 (Washington, D.C.: Oct. 19, 2007).

[2] Our analysis of energy prices and energy financial markets is generally limited to the time period from January 2002 through December 2006.

ernment regulators and agencies involved with the energy markets. This work was done in accordance with generally accepted government auditing standards.

Summary

Physical and derivatives markets for crude oil, unleaded gasoline, heating oil, and natural gas have experienced substantial changes in recent years. Within the physical market, tight supply and rising global demand, ongoing political instability in oil-producing regions, limited refining capacity, and other supply disruptions all contributed to higher prices. While these changes were occurring in the physical markets, in the derivatives markets volatility of energy prices generally remained above historic averages for most of the period but declined during 2006 to levels at or near the historical average. Moreover, trading volumes for futures increased, at least in part because a growing number of managed-money traders (including hedge funds) began to see energy futures as attractive investment alternatives. Another change occurring during this time was the increased trading of energy derivatives outside the organized exchanges. Trading in these markets—specifically electronic commercial markets and over-the-counter (OTC) markets—is much less transparent than trading on futures exchanges, and comprehensive data are not available because these energy markets are not regulated. Given that the developments in the physical and derivatives markets were occurring simultaneously, determining their effect on energy prices is difficult. Continued monitoring of the various factors that affect market prices, and how those factors are changing, will be important in protecting the public and ensuring market integrity.

Energy derivatives are traded on futures exchanges and off-exchange in exempt commercial and OTC markets.[3] Exempt commercial markets are electronic trading facilities that trade exempt commodities, including energy commodities, on a principal-to-principal basis solely between commercial entities meeting certain eligibility requirements. In the OTC markets, parties meeting certain requirements can enter into bilateral energy derivatives transactions. Unlike the futures exchanges, which are subject to comprehensive oversight by CFTC, exempt commercial markets and OTC markets are not subject to general CFTC oversight, although CFTC can enforce the CEA's antimanipulation provisions and, where applicable, the antifraud provisions. To provide transparency about trading on the futures exchanges, CFTC routinely publicly reports aggregate information on trading by large commercial (such as oil companies, refineries, and other hedge traders) and noncommercial (such as hedge funds) participants that occurs on the exchanges. However, in the way the data are currently categorized, no distinction is made between commercial traders who use the exchanges to hedge their positions in the physical markets and those commercial traders, such as investment banks, who trade futures to hedge their trading in off-exchange derivatives. Given the developments and growth in the energy trading markets, questions have been raised over whether CFTC needs broader authority over the off-exchange derivative markets, particularly those involving exempt commodities and exempt commercial markets.

At an operational level, we also reported that while CFTC conducts reporting, surveillance, and enforcement activities in the energy markets to help provide transparency to the public, detect fraudulent or manipulative trading practices, and deter abuses, the effectiveness of these efforts is unclear. For example:

- Although CFTC monitors exchange trading activity through its surveillance program and gathers additional information from NYMEX officials, traders, or other sources to determine if further action is warranted, staff did not routinely document the results of these inquiries. Instead, they kept formal records of their findings only in cases in which improper trading was identified. As a result, CFTC may be limiting its opportunities to identify trends and its ability to measure the extent and usefulness of its monitoring activities.
- We also found that CFTC has successfully pursued energy-related cases, but we were not able to determine how effectively CFTC's enforcement activities were in identifying violations and deterring misconduct because the agency lacked meaningful outcome-based measures.

Our report includes a matter for Congressional consideration and three recommendations to CFTC. In light of recent developments and the uncertainty over the adequacy of CFTC's oversight, we recommend that Congress, as part of the CFTC reauthorization process, further explore whether the current regulatory structure for energy derivatives, in particular for those traded in exempt commercial markets, adequately provides for fair trading and accurate pricing of energy com-

[3] Energy swap transactions also may be conducted off-exchange if they satisfy the requirements for excluded swap transactions contained in section 2(g) of the Commodity Exchange Act.

modities. To improve the transparency of market activities and the functioning of CFTC's oversight, we recommend that CFTC reconsider how information it publishes in trading reports for energy products could be improved and CFTC has agreed to reexamine the classifications used in these reports. CFTC also agreed with our recommendations aimed at better documenting its surveillance activities and developing more outcome-based performance measures and has taken steps to implement them.

Background

Energy commodities are bought and sold on both the physical and financial markets. The physical market includes the spot market where products such as crude oil or gasoline are bought and sold for immediate or near-term delivery by producers, wholesalers, and retailers. Spot transactions take place between commercial participants for a particular energy product for immediate delivery at a specific location. For example, the U.S. spot market for West Texas Intermediate crude oil is the pipeline hub near Cushing, Oklahoma, while a major spot market for natural gas operates at the Henry Hub near Erath, Louisiana. The prices set in the specific spot markets provide a reference point that buyers and sellers use to set the price for other types of the commodity traded at other locations.

In addition to the spot markets, derivatives based on energy commodities are traded in financial markets. The value of the derivative contract depends on the performance of the underlying asset—for example, crude oil or natural gas. Derivatives include futures, options, and swaps. Energy futures include standardized exchange-traded contracts for future delivery of a specific crude oil, heating oil, natural gas, or gasoline product at a particular spot market location. An exchange designated by CFTC as a contract market standardizes the contracts. The owner of an energy futures contract is obligated to buy or sell the commodity at a specified price and future date. However, the contractual obligation may be removed at any time before the contract expiration date if the owner sells or purchases other contracts with terms that offset the original contract. In practice, most futures contracts on NYMEX are liquidated via offset, so that physical delivery of the underlying commodity is relatively rare.

Market participants use futures markets to offset the risk caused by changes in prices, to discover commodity prices, and to speculate on price changes. Some buyers and sellers of energy commodities in the physical markets trade in futures contracts to offset or "hedge" the risks they face from price changes in the physical market. Exempt commercial markets and OTC derivatives are also used to hedge this risk. The ability to reduce their price risk is an important concern for buyers and sellers of energy commodities, because wide fluctuations in cash market prices introduce uncertainty for producers, distributors, and consumers of commodities and make investment planning, budgeting, and forecasting more difficult. To manage price risk, market participants may shift it to others more willing to assume the risk or to those having different risk situations. For example, if a petroleum refiner wants to lower its risk of losing money because of price volatility, it could lock in a price by selling futures contracts to deliver the gasoline in 6 months at a guaranteed price. Without futures contracts to manage risk, producers, refiners, and others would likely face greater uncertainty.

By establishing prices for future delivery, the futures market also helps buyers and sellers determine or "discover" the price of commodities in the physical markets, thus linking the two markets together. Markets are best able to perform price discovery when (1) participants have current information about the fundamental market forces of supply and demand, (2) large numbers of participants are active in the market, and (3) the market is transparent. Market participants monitor and analyze a myriad of information on the factors that currently affect and that they expect to affect the supply of and demand for energy commodities. With that information, participants buy or sell an energy commodity contract at the price they believe the commodity will sell for on the delivery date. The futures market, in effect, distills the diverse views of market participants into a single price. In turn, buyers and sellers of physical commodities may consider those predictions about future prices, among other factors, when setting prices on the spot and retail markets.

Other participants, such as investment banks and hedge funds, which do not have a commercial interest in the underlying commodities, generally use the futures market for profit. These speculators provide liquidity to the market but also take on risks that other participants, such as hedgers, seek to avoid. In addition, arbitrageurs attempt to make a profit by simultaneously entering into several transactions in multiple markets in an effort to benefit from price discrepancies across these markets.

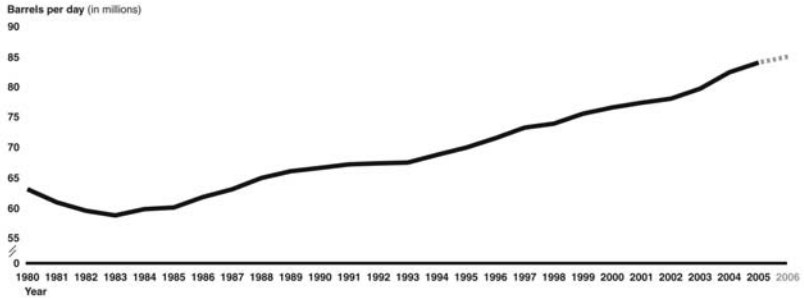
Several Factors Have Caused Changes in the Energy Markets, Potentially Affecting Energy Prices

The physical markets for energy commodities underwent change and turmoil from 2002 through 2006, which affected prices in the spot and futures markets. We reported that numerous changes in both the physical and futures markets may have affected energy prices. However, because these changes occurred simultaneously, identifying the specific effect of any one of these changes on energy prices is difficult.

Various Changes in the Physical Market Contributed to Rising Prices

The physical energy markets have undergone substantial change and turmoil during this period, which can affect spot and futures markets. Like many others, we found that a number of fundamental supply and demand conditions can affect prices. According to the Energy Information Administration (EIA), world oil demand has grown since 1983 from a low of about 59 million barrels per day in 1983 to more than 85 million barrels per day in 2006 (*fig. 1*). While the United States accounts for about a quarter of this demand, rapid economic growth in Asia also has stimulated a strong demand for energy commodities. For example, EIA data show that during this time frame, China's average daily demand for crude oil increased almost fourfold.

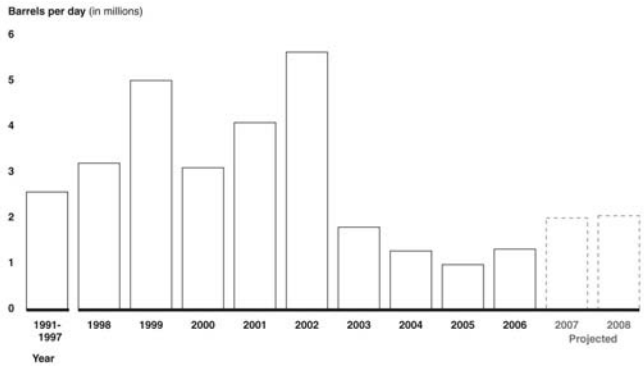
Figure 1: Increase in World Demand for Crude Oil (Actual and Estimated), 1980–2006



Source: GAO analysis of EIA data.
Note: The world oil demand data for 2006 represent a preliminary estimate.

The growth in demand does not, by itself, lead to higher prices for crude oil or any other energy commodity. For example, if the growth in demand were exceeded by a growth in supply, prices would fall, other things remaining constant. However, according to EIA, the growth in demand outpaced the growth in supply, even with spare production capacity included in supply. Spare production capacity is surplus oil that can be produced and brought to the market relatively quickly to re-balance the market if there is a supply disruption anywhere in the world oil market. As shown in *figure 2*, EIA estimates that global spare production capacity in 2006 was about 1.3 million barrels per day, compared with spare capability of about 10 million barrels per day in the mid-1980s and about 5.6 million barrels a day as recently as 2002.

Figure 2: Estimates of World Oil Spare Production Capacity, 1991–2008



Source: GAO analysis of EIA data.

Major weather and political events also can lead to supply disruptions and higher prices. In its analysis, EIA has cited the following examples:

- Hurricanes Katrina and Rita removed about 450,000 barrels per day from the world oil market from June 2005 to June 2006.
- Instability in major oil-producing countries of the Organization of Petroleum Exporting Countries (OPEC), such as Iran, Iraq, and Nigeria, have lowered production in some cases and increased the risk of future production shortfalls in others.
- Oil production in Russia, a major driver of non-OPEC supply growth during the early 2000s, was adversely affected by a worsened investment climate as the government raised export and extraction taxes.

The supply of crude oil affects the supply of gasoline and heating oil, and just as production capacity affects the supply of crude oil, refining capacity affects the supply of those products distilled from crude oil. As we have reported, refining capacity in the United States has not expanded at the same pace as the demand for gasoline.[4] Inventory, another factor affecting supplies and therefore prices, is particularly crucial to the supply and demand balance, because it can provide a cushion against price spikes if, for example, production is temporarily disrupted by a refinery outage or other event. Trends toward lower levels of inventory may reduce the costs of producing gasoline, but such trends also may cause prices to be more volatile. That is, when a supply disruption occurs or there is an increase in demand, there are fewer stocks of readily available gasoline to draw on, putting upward pressure on prices.

Another consideration is that the value of the U.S. dollar on open currency markets could affect crude oil prices. For example, because crude oil is typically denominated in U.S. dollars, the payments that oil-producing countries receive for their oil also are denominated in U.S. dollars. As a result, a weak U.S. dollar decreases the value of the oil sold at a given price, and oil-producing countries may wish to increase prices for their crude oil in order to maintain the purchasing power in the face of a weakening U.S. dollar to the extent they can.

The Effect on Prices of Relatively High but Falling Volatility and a Growing Volume of Trading in Derivatives Is Unclear

As you can see, conditions in the physical markets have undergone changes that can help explain at least some of the increases in both physical and derivatives commodity prices. As we have previously reported, futures prices typically reflect the effects of world events on the price of the underlying commodity such as crude oil.[5] For example, political instability and terrorist acts in countries that supply oil create uncertainties about future supplies, which are reflected in futures prices. Conversely, news about a new oil discovery that would increase world oil supply could

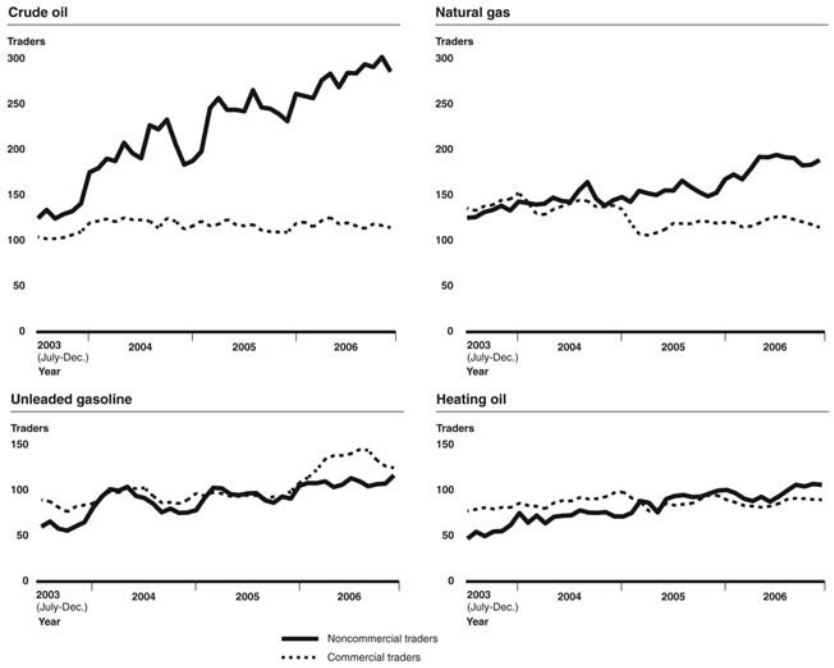
[4] GAO, *Motor Fuels: Understanding the Factors That Influence the Retail Price of Gasoline*, GAO–05–525SP (Washington, D.C.: May 2005).
[5] GAO–05–525SP.

result in lower futures prices. In other words, changes in the physical markets influence futures prices.

At the same time that physical markets were undergoing changes, we found that financial markets also were amidst change and evolution. For example, the annual historical volatilities between 2000 and 2006—measured using the relative change in daily prices of energy futures—generally were above or near their long-term averages, although crude oil and heating oil declined below the average and gasoline declined slightly at the end of that period. We also found that the annual volatility of natural gas fluctuated more widely than that of the other three commodities and increased in 2006 even though prices largely declined from the levels reached in 2005. Although higher volatility is often equated with higher prices, this pattern illustrates that an increase in volatility does not necessarily mean that price levels will increase. In other words, price volatility measures the variability of prices rather than the direction of the price changes.

Elsewhere in the futures market, we found an increase in the number of noncommercial traders such as managed money traders.[6] Attracted in part by the trends in prices and volatility, a growing number of traders sought opportunities to hedge against those changes or profit from them. Using CFTC's large trader data, we found that from July 2003 to December 2006, crude oil futures and options contracts experienced the most dramatic increase, with the average number of noncommercial traders more than doubling from about 125 to about 286. As shown in *figure 3*, while the growth was less dramatic in the other commodities, the average number of noncommercial traders also showed an upward trend for unleaded gasoline, heating oil, and natural gas.

Figure 3: Average Daily Number of Large Commercial and Noncommercial Traders per Month, July 2003–December 2006



Source: GAO analysis of CFTC data.

Not surprisingly, our work also revealed that as the number of traders increased, so did the trading volume on NYMEX for all energy futures contracts, particularly crude oil and natural gas. Average daily contract volume for crude oil increased by 90 percent from 2001 through 2006, and natural gas increased by just over 90 per-

[6] CFTC collects data on traders holding positions at or above specific reporting levels set by the Commission. This information is collected as part of CFTC's large trader reporting system.

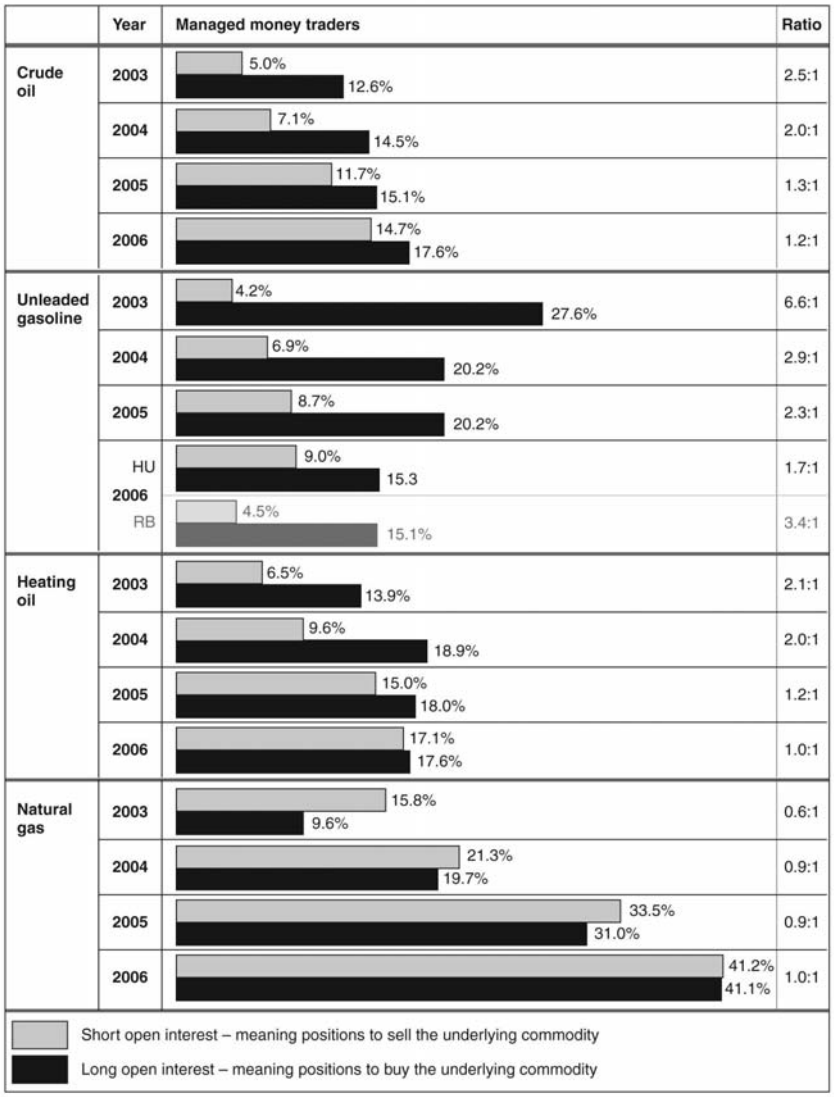
cent. Unleaded gasoline and heating oil experienced less dramatic growth in their trading volumes over this period.

While much harder to quantify, another notable trend was the significant increase in the amount of energy derivatives traded outside exchanges. Trading in these markets is much less transparent, and comprehensive data are not available because these energy markets are not regulated. However, using the Bank for International Settlements data as a rough proxy for trends in the trading volume of OTC energy derivatives, the face value or notional amounts outstanding of OTC commodity derivatives excluding precious metals, such as gold, grew from December 2001 to December 2005 by more than 850 percent to over $3.2 trillion.[7]

Further, while some market observers believe that managed money traders were exerting upward pressure on prices by predominantly buying futures contracts, CFTC data we analyzed revealed that from the middle of 2003 through the end of 2006, the trading activity of managed money participants became increasingly balanced between buying (those that expect prices to go up) and selling (those that expect prices to go down). Using CFTC large trader reporting data, we found that from July 2003 through December 2006, managed money traders' ratio of buying (long) to selling (short) open interest positions was 2.5:1 indicating that on the whole, this category of participants was 2.5 times as likely to expect prices to rise as opposed to fall throughout that period, which they did. However, as *figure 4* illustrates, by 2006, this ratio fell to 1.2:1, suggesting that managed money traders as a whole were more evenly divided in their expectations about future prices. As you can see, managed money trading in unleaded gasoline, heating oil, and natural gas showed similar trends.

[7] The Bank for International Settlements is an international organization that fosters international monetary and financial cooperation and serves as a bank for central banks.

Figure 4: Percentage of Long and Short Open Interest in Futures and Options for Managed Money Traders, July 2003–December 2006



Source: GAO analysis of CFTC data.

Note: Data for 2003 were for July through December. The percentages indicate what portion of long and short open interest was held by managed money traders. For example, in 2004, managed money traders held 14.5 percent of the total long open interest for crude oil and 7.1 percent of the total short open interest. Because data are not included for all categories of traders, the percentages for these three categories within a particular period do not total 100. These data should be viewed as a general overview of managed money traders' positions. They do not provide insights into how traders' individual positions changed over time. Our data for 2006 include

contract trading data for NYMEX reformulated gasoline blendstock (RB) and for the NYMEX gasoline contract (HU) that began to replace RB.

Overall, we found that views were mixed about whether these trends put any upward pressure on prices. Some market participants and observers have concluded that large purchases of oil futures contracts by speculators could have created an additional demand for oil that could lead to higher prices. Conversely, some Federal agencies and other market observers took the position that speculative trading activity did not have a significant impact on prices. For example, an April 2005 CFTC study of the markets concluded that increased trading by speculative traders, including hedge funds, did not lead to higher energy prices or volatility. This study also argued that hedge funds provided increased liquidity to the market and dampened volatility. Still others told us that while speculative trading in the futures market could contribute to short-term price movements in the physical markets, they did not believe it was possible to sustain a speculative "bubble" over time, because the two markets were linked and both responded to information about changes in supply and demand caused by such factors as the weather or geographical events. In the view of these observers and market participants, speculation could not lead to artificially high or low prices over a long period.

CFTC Oversees Exchanges and Has Limited Authority Over Other Derivatives Markets

Under CEA, CFTC's authority for protecting market users from fraudulent, manipulative, and abusive practices in energy derivatives trading is primarily focused on the operations of traditional futures exchanges, such as NYMEX, where energy futures are traded. Off exchange markets, which are available only to eligible traders of certain commodities under specified conditions, are not regulated, although CFTC may enforce antimanipulation and antifraud provisions of the CEA with respect to trading in those markets. The growth in trading off-exchange has raised questions about the sufficiency of CFTC's limited authority over these markets. These changes and innovations also have brought into question the methods CFTC uses to categorize published data about futures trading by participants in the off-exchange markets and whether information about their activities in off-exchange markets would be useful to the public. CFTC is taking steps to better understand these issues. Most importantly, it is currently examining the relationship between trading in the regulated and exempt energy markets and the role this trading plays in the price discovery process. It is also examining the sufficiency of the scope of its authority over these markets—an issue that will warrant further examination as part of the CFTC reauthorization process.

CFTC Has General Oversight Authority Over Futures Exchanges, but Information on These Exchanges Reported to the Public Has Not Kept Pace With Changing Market Conditions

To help provide transparency in the markets, CFTC provides the public information on open interest in exchange-traded futures and options by commercial and noncommercial traders for various commodities in its weekly Commitment of Traders (COT) reports.[8] As we reported, CFTC observed that the exchange-traded derivatives markets, as well as trading patterns and practices, have evolved. In 2006, CFTC initiated a comprehensive review of the COT reporting program out of concern that the reports in their present form might not accurately reflect the commercial or noncommercial nature of positions held by nontraditional hedgers, such as swaps dealers.[9] A disconnect between the classifications and evolving trading activity could distort the accuracy and relevance of reported information to users and the public, thereby limiting its usefulness for both.

In December 2006, CFTC announced a 2 year pilot program for publishing a supplemental COT report that includes positions of commodity index traders in a separate category. However, the pilot does not include any energy commodities. Although commodity index traders are active in energy markets, according to CFTC officials, currently available data would not permit an accurate breakout of index trading in these markets. For example, some traders, such as commodity index pools, use the futures markets to hedge commodity index positions they hold in the OTC market. However, these traders also may have positions in the physical markets, which means the reports that CTFC receives on market activities, which do not include such off-exchange transactions, may not present an accurate picture of all positions in the market place for the commodity. In response to our recommendation to reex-

[8] These reports include the number of traders, changes since the last report, and open positions.

[9] 71 *Fed. Reg.* 35627, 35630–31 (June 21, 2006).

amine the COT classifications for energy markets, CFTC agreed to explore whether the classifications should be refined to improve their accuracy and relevance.

CFTC Authority Over Exempt Commercial Markets and OTC Markets Is Limited, and Views Vary About the Sufficiency of Its Regulatory Authority With Respect to Off-Exchange Energy Derivatives

Now let me address some of the larger policy issues associated with CFTC's oversight of these markets. Under CEA, CFTC's authority for protecting market users from fraudulent, manipulative, and abusive practices in energy derivatives trading is primarily focused on the operations of traditional futures exchanges, such as NYMEX, where energy futures are traded. Currently, CFTC receives limited information on derivatives trading on exempt commercial markets—for example, records of allegations or complaints of suspected fraud or manipulation, and price, quantity, and other data on contracts that average five or more trades a day. The agency may receive limited information, such as trading records, from OTC participants to help CFTC enforce the CEA's antifraud or antimanipulation provisions. The scope of CFTC's oversight authority has raised concerns among some Members of Congress and others that activities on these markets are largely unregulated, and that additional CFTC oversight is needed.

While some observers have called for more oversight of OTC derivatives, most notably for CFTC to be given greater oversight authority of this market, others oppose any such action. Supporters of more CFTC oversight authority believe that regulation of OTC derivatives markets is necessary to protect the regulated markets and consumers from potential abuse and possible manipulation. One of their concerns is that, due to the lack of complete information on the size of this market or the terms of the contracts, CFTC may not be assured that trading on the OTC market is not adversely affecting the regulated markets and, ultimately, consumers. However others, including the President's Working Group, have concluded that OTC derivatives generally are not subject to manipulation because contracts are settled in cash on the basis of a rate or price determined in a separate, highly liquid market that does not serve a significant price discovery function.[10] The Working Group also noted that if electronic markets were to develop and serve a price discovery function, then consideration should be given to enacting a limited regulatory regime aimed at enhancing market transparency and efficiency through CFTC, as the regulator of exchange-traded derivatives.

However, the lack of reported data about this market makes addressing concerns about its function and effect on regulated markets and entities challenging. In a June 2007 *Federal Register* release clarifying its large trader reporting authority, CFTC noted that having data about the off-exchange positions of traders with large positions on regulated futures exchanges could enhance the Commission's ability to deter and prevent price manipulation or other disruptions to the integrity of the regulated futures markets.[11] According to CFTC officials, the Commission has proposed amendments to clarify its authority under the CEA to collect information and bring fraud actions in principal-to-principal transactions in these markets, enhancing CFTC's ability to enforce antifraud provisions of the CEA.[12]

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[10] President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (Nov. 9, 1999). Members of group are the Chairman of CFTC, the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, and the Chairman of the Securities and Exchange Commission.

[11] As stated by CFTC, the purpose of the proposed regulation is to make it explicit that persons holding or controlling reportable positions on a reporting market must retain books and records and make available to the Commission upon request any pertinent information with respect to all other positions and transactions in the commodity in which the trader has a reportable position, including positions held or controlled or transactions executed over-the-counter or pursuant to sections 2(d), 2(g) or 2(h)(1)–(2) of the CEA or part 35 of the Commission's regulations, on exempt commercial markets operating pursuant to sections 2(h)(3)–(5) of the CEA, on exempt boards of trade operating pursuant to Section 5d of the CEA, and on foreign boards of trade (hereinafter referred to collectively as non-reporting transactions); and to make the regulation clearer and more complete with respect to hedging activity. The purpose of the amendments is to clarify CFTC's regulatory reporting requirements for such traders. 72 *Fed. Reg.* 34413.

[12] Section 4b of the CEA is CFTC's main antifraud authority. In a November 2000 decision, the 7th Circuit Court of Appeals ruled that CFTC only could use section 4b in intermediated transactions—those involving a broker. *Commodity Trend Service, Inc.* v. *CFTC*, 233 F.3d 981, 991–992 (7th Cir. 2000). As amended by the Commodity Futures Modernization Act of 2000, the CEA permits off-exchange futures and options transactions that are done on a principal-to-principal basis, such as energy transactions pursuant to CEA sections 2(h)(1) and 2(h)(3). According to CFTC, House and Senate CFTC reauthorization bills introduced during the 109th Congress (H.R. 4473 and S. 1566) would have amended section 4b to clarify that Congress intends for

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Also, in September 2007, CFTC conducted a hearing to begin examining trading on regulated exchanges and exempt commercial markets more closely. The hearing focused on a number of issues, including:

- the current tiered regulatory approach established by the Commodity Futures Modernization Act, which amended the CEA, and whether this model is beneficial;
- the similarities and differences between exempt commercial markets and regulated exchanges, and the associated regulatory risks of each market; and
- the types of regulatory or legislative changes that might be appropriate to address any identified risks.

Given ongoing questions about the similarity of products traded on the markets and how and whether exempt markets play a role in the price discovery process and whether existing reporting requirements are sufficient, we recommend that Congress take up this issue during the CFTC reauthorization process to begin to answer some of these questions and the implications for the current regulatory structure in light of the changes that have occurred in this market.

CFTC Engages in Large Trader Reporting, Surveillance, and Enforcement Activities, but the Effectiveness of the Activities Is Largely Uncertain

CFTC provides oversight for commodity futures markets by analyzing large trader reporting data, conducting routine surveillance, and investigating and taking enforcement actions against market participants and others. The Commission uses information gathered from surveillance activities to identify unusual trading activity and possible market abuse. In particular, CFTC's large trader reporting system (LTRS) provides essential information on the majority of all trading activity on futures exchanges. CFTC staff said they routinely investigate traders with large open positions, but do not routinely maintain information about such inquiries, thereby making it difficult to determine the usefulness and extent of these activities. According to recent data provided by CFTC, about 10 percent of the enforcement actions involved energy-related commodities. However, as with programs operating in regulatory environments where performance is not easily measurable, evaluating the effectiveness of CFTC's enforcement activities is challenging because it lacks effective outcome-based performance measures.

CFTC Oversight Includes Surveillance of Energy Futures Trading, but the Full Extent of Follow-Up Activities Is Uncertain

CFTC conducts regular market surveillance and oversight of energy trading on NYMEX and other futures exchanges, focusing on detecting and preventing disruptive practices before they occur and keeping the CFTC Commissioners informed of possible manipulation or abuse. According to CFTC staff, when a potential market problem has been identified, surveillance staff generally contact the exchange or traders for more information. To confirm positions and determine intent, staff may question exchange employees, brokers, or traders. According to the staff, CFTC's Division of Market Oversight may issue a warning letter or make a referral to the Division of Enforcement to conduct a nonpublic investigation into the trading activity. Markets where surveillance problems have not been resolved may be included in reports presented to the Commission at weekly surveillance meetings.

According to CFTC staff, they routinely make inquiries about traders with large open positions approaching expiration, but formal records of their findings are only kept in cases with evidence of improper trading. If LTRS data revealed that a trader had a large open market position that could disrupt markets if it were not closed before expiration, CFTC staff would contact the trader to determine why the trader had the position and what plans the trader had to close the position before expiration or ensure that the trader was able to take delivery. If the trader provided a reasonable explanation for the position and a reasonable delivery or liquidation strategy, staff said no further action would be required. CFTC staff said they would document such contacts on the basis of their importance in either informal notes, e-mails to supervisors, or informal memorandums. According to one CFTC official, no formal record would be made unless some signal indicated improper trading activity. However, without such data, CFTC's measures of the effectiveness of its actions to combat fraud and manipulation in the markets would not reflect all surveillance activity, and CFTC management might miss opportunities to identify trends in activities or markets and better target its limited resources. In response to our

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CFTC to enforce section 4b in connection with off-exchange principal-to-principal futures transactions, including exempt commodity transactions in energy under section 2(h) as well as all transactions conducted on derivatives transaction execution facilities.

recommendation, CFTC agreed to improve its documentation of its surveillance activities.

CFTC Energy-Related Enforcement Actions Generally Involved Allegations of False Reporting and Attempted Manipulation, but Its Program Received a Mixed Rating and Lacks Effective Outcome-Based Performance Measures

CFTC's Division of Enforcement is charged with enforcing the antimanipulation sections of the CEA.[13] The enforcement actions CFTC has taken in its energy-related cases generally have involved false public reporting as a method of attempting to manipulate prices on both the NYMEX futures market and the off-exchange markets. CFTC officials said that from October 2000 to September 2005, the agency initiated 287 enforcement cases and more than 30 of these cases involved energy trading. In the past several months, CFTC has taken a series of actions involving energy commodities, including allegations of false reporting, attempted manipulation of NYMEX natural gas futures prices, and attempted manipulation of physical natural gas prices.

Although CFTC has undertaken enforcement actions and levied fines, measuring the effectiveness of these activities is an ongoing challenge. For example, the Office of Management and Budget's most recent 2004 Program Assessment Rating Tool (PART) assessment of the CFTC enforcement program identified a number of limitations of CFTC's performance measures.[14] As is the case with most enforcement programs, identifying outcome-oriented performance measures can be particularly challenging.[15] However, as we point out in the report, there are a number of other ways to evaluate program effectiveness, such as using expert panel reviews, customer service surveys, and process and outcome evaluations. We have found with other programs that the form of the evaluations reflects differences in program structure and anticipated outcomes, and that the evaluations are designed around the programs and what they aim to achieve.[16] Without utilizing these or other methods to evaluate program effectiveness, CFTC is unable to demonstrate whether its enforcement program is meeting its overall objectives. CFTC has agreed that this is a matter that should be examined and has included development of measures to evaluate its effectiveness in its strategic plan and has requested funding to study the feasibility of developing more meaningful measures.

In closing, I would like to reemphasize the difficulty in attributing increased energy prices to any one of the numerous changes in the physical or derivatives markets. As I have mentioned, our research shows that the physical and derivatives markets have both undergone substantial change and evolution, and market participant and regulatory views were mixed about the extent to which these developments exerted upward pressure on prices. Because of the importance of understanding the potential effects of such developments in these markets, ongoing review and analysis are warranted. As the scope of CFTC's authority is debated, additional information is needed to understand what may need to be done to best protect investors from fraudulent, manipulative, and abusive practices. Such information includes:

- how different or similar are the characteristics and uses of exchange and off-exchange products being traded and do these continue to justify different regulatory treatment;
- to what extent does trading in off-exchange financial derivatives affect price discovery and what are the regulatory and policy implications;
- how large of an effect are nontraditional market participants, such as commodity index funds, having in these markets; and
- are the changes in the energy markets unique or are such concerns also worth reviewing for other commodity markets.

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[13] Section 9(a)(2) of the CEA prohibits "(a)ny person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless, or other means of communication false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity interstate commerce . . ."

[14] The assessment includes a series of questions meant to serve as a diagnostic performance tool, drawing on available program performance and evaluation information to form conclusions about program benefits and recommend adjustments that may improve results.

[15] GAO, *Results Oriented Government: GPRA Has Established a Solid Foundation for Achieving Greater Results,* GAO–04–594T (Washington, D.C.: Mar. 31, 2004).

[16] GAO, *Program Evaluation: OMB's PART Reviews Increased Agencies' Attention to Improving Evidence of Program Results,* GAO–06–67 (Washington, D.C.: Oct. 28, 2005).

By answering questions such as these, CFTC and the Congress will be better positioned to determine what changes, if any, may be needed to oversee these markets.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions that you or other Members of the Subcommittee might have.

GAO Contacts

For further information about this testimony, please contact Orice M. Williams on (202) 512–8678 or at *williamso@gao.gov*.

Staff Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions include Cody Goebel (Assistant Director), John Forrester, Barbara Roesmann, and Paul Thompson.

The CHAIRMAN. Thank you and let me thank both of you for your testimony.

And I would now recognize myself for 5 minutes.

Mr. Lukken, in the hearings and, well, first of all, let me say thank you for being here and if I understood you correctly you indicated that the entire Working Group supports this proposal. And I assume the President's total Working Group unanimously is on board, is that correct?

Mr. LUKKEN. Well this has not come before the Working Group as a proposal. This was the leadership of the CFTC to put forward a Commission document. However, having said that the PWG during this whole development was kept apprised of what we were doing, why we were doing it and, certainly, being briefed on these issues. I could say, certainly, they don't oppose the proposal but this has not come before the President's Working Group in itself as an official document.

The CHAIRMAN. Well, let me follow-up, do you plan to share with them and get their——

Mr. LUKKEN. We sought their input. We talked to them during this whole development and they are fully apprised of us coming forward here today, and comfortable with our leadership.

The CHAIRMAN. Okay. Thank you.

In our hearing in late September, Mr. Roth, who is President of National Futures Association described in detail the situation occurring in off-exchange retail trading of foreign contracts or forex. His testimony stated that forex dealers and members at the NFA constitute less than one percent of its membership but account for more than 20 percent of the current customer complaints, and 50 percent of NFA's enforcement docket, and 50 percent of emergency actions the NFA has taken this year. To address this problem, he recommended imposing that higher capitalization requirement of $20 million on forex dealers and requiring futures commission merchants who want to engage in retail forex transactions to also be actively engaged in exchange trading at a regulated exchange. Tell us about the Commission's experience in overseeing retail off-exchange forex trading, and your thoughts on whether the recommendations of Mr. Roth would weed out some of the problem cases that appear to be in this sector of futures trading.

Mr. LUKKEN. Well as I mentioned in my testimony, we certainly are very active in the forex area having brought 98 cases over the last several years in forex. NFA is also on the frontline of this fraud epidemic in the forex area. We have worked with them over the last several years to raise capital requirements to put rules

into place to ensure that legitimate business can continue to occur in the foreign currency trading. Those that are trying to scam others are being shut down—that they are, indeed, businesses with appropriate resources and financial controls in place. So, I would say that NFA has, or is very close to this and, certainly, we would be supportive of adequate capital requirements put on to these types of firms.

The CHAIRMAN. Thank you. On another subject, the President's Working Group recommended language to address the *Zelener* case that was narrowly tailored to foreign exchange trading. Some in the industry have suggested that such a narrow fix will not prevent the purveyors of these *Zelener*-type contracts from simply crossing off foreign exchanges and substituting another commodity. Assuming the PWG language were to become law, can you specifically cite for the Subcommittee what parts of the Commodity Exchange Act would prevent someone from using the same contract but for, let's say, natural gas, corn, wheat or another commodity so we don't have to worry about these problems reoccurring.

Mr. LUKKEN. Well, I think the reason that the President's Working Group focused on foreign currency was the nature of the product itself. In some ways it is unique compared to other commodities because the definition of what is or is not a futures contract often revolves around whether something is—somebody is able to make or take delivery. With foreign currency that is pretty easy. It is a bank account. It is not too difficult to make and take delivery for foreign currency transactions. When you get into grains, oil, a shipment of oil, these other products, it is much more difficult to show that you are able to make and take delivery. Over the 3 years since the *Zelener* case, we have not seen a migration to other commodities. It has remained in the forex area. I am not saying that it may not someday migrate in some area that we can't think about, but I think the narrow fix would take care of a substantial or vast amount of the problems that we are seeing now in the foreign currency fraud area.

The CHAIRMAN. All right. Let me follow-up because it has been now about 2 years since the President's Working Group made that recommendation and a lot has changed. As a matter of fact, the Commission has changed.

Mr. LUKKEN. Yes.

The CHAIRMAN. So am I taking that to be your recommendation that you have reviewed this, you feel like it would be adequate and that we shouldn't take another look at it before we move forward?

Mr. LUKKEN. Absolutely, I think that the fix that has been proposed would take care of a substantial amount of the problems that we face. You know, others may want to go further, but if we are looking for something that has consensus, that has already passed this Committee and the House already, this is going to take care of a vast majority of the problem.

The CHAIRMAN. Would you say that all the Commissioners have that same, are in agreement with that?

Mr. LUKKEN. They certainly have signed on to my testimony advancing this but some, obviously, you will have to talk to the other Commissioners and whether they would prefer a broader approach

or not. But I think I could safely say that at a minimum, this needs to be done this——

The CHAIRMAN. Well, let me just say, it would be helpful for this Committee to know that if you would submit that to us——

Mr. LUKKEN. Sure.

The CHAIRMAN.—later in writing, please. Thank you. And I have gone over my time and I apologize to Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you very much. Chairman Lukken, thank you. You testified or the Commission, I guess, testified that changes to our last CFTC reauthorization bill in the 109th, there were specific proposals in regard to energy futures and transparency and, I believe, your testimony then was that those changes for price transparency were unnecessary. Does your position, the Commission's position, remain the same?

Mr. LUKKEN. Which provision? This was in regards to what type of transaction?

Mr. MORAN. This is the Title II Amendments that were proposed by several Members of our Committee.

Mr. LUKKEN. Well, I think either the focus of our recommendations today are dealing with exempt commercial markets, that once price discovery occurs in these types of transactions, that certain authorities would then be required upon those ECMs. It is part of that report that in regards to bilateral transactions that are occurring in this energy area that there is not consensus that more regulation needs to happen in regards to the bilateral markets. But as far as the ECMs that serve a price discovery function that has been our focus of this report.

Mr. MORAN. I think I understand your answer. Let me take what you just said a bit further with a slightly different line of questioning. As I understand the recommendation is that you would like four new regulatory authorities over the ECMs, and that regulatory authority would come into play when, as I think you say, an ECM futures contract serves a significant price discovery function.

Mr. LUKKEN. Correct.

Mr. MORAN. What criteria would be used to determine when that ECM future serves that function?

Mr. LUKKEN. We look at two broad criteria in making that determination. The first is volume, that there has to be a material amount of volume in the contract in order to warrant the public's attention in this area. Second, that it needs to either be linked to a regulated market contractually, such that we are seeing with the ICE contract, or be a material price reference, meaning that a price discovery mechanism can be referenced by the public outside of a futures exchange. So, if something might develop on ICE it is not linked to a NYMEX product, but that people are referencing an interstate commerce outside of those transactions. So if there is either that linkage, material price referencing and some type of material trading, that is going to form our basis for determining whether something is a significant price discovery product.

Mr. MORAN. And, finally, are there areas of disagreement with the GAO in regard to their report, their recommendations and suggestions. Would you respond to anything that is in that report that you have disagreement with?

Mr. LUKKEN. No, we fully support the recommendations made by GAO and will work to try to resolve those. One of the issues dealing with, I think, the commitment of trader data that is currently being published for agricultural products for commodity index traders, we are holding an Agricultural Advisory Committee meeting on December 8, or I am sorry, December 6 at the Commission. Commissioner Dunn heads up that committee for the CFTC and one of the issues in looking at the commitment of traders, index trader program, and whether that is working well for agricultural products but also should it be extended to other products? And so that is going to be a time for us to explore whether this can go to other types of products including energy, and other types of commodities. When we first looked at this, however, I will note that it was easier to designate index traders for agricultural products because most of the index traders were just doing that. They were involved in index trading on those markets but when you look to products beyond agriculture, such as energy and others, oftentimes the index traders wear several hats. They are not only doing their index trading but they are also doing swap dealing and off-setting those transactions and also proprietary trading. Sometimes it is difficult to pull out of that data something that is meaningful that would be meaningful for the market participants. But nevertheless, we plan to look at this, review it and then see if it is something that the public would benefit from.

Mr. MORAN. Mr. Chairman, briefly, we are now operating under a continuing resolution, have there been consequences to the CFTC authorization, I am sorry, operations as a result of this particular circumstance we once again find ourselves in?

Mr. LUKKEN. Well, we have to put halts on hiring people that we had planned to hire to oversee these markets and that is difficult to defer that, technology upgrades have had to have been put on hold and there are a variety of things, like travel only for certain essential business purposes for a lot of the Commission employees. It is difficult to give depositions in other parts of the country if you are not able to travel there. So this is difficult, we are able to do our job but we are stretched thin.

Mr. MORAN. Mr. Chairman, thank you very much.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. I have a couple of questions for you, Chairman Lukken and Ms. Williams. First of all, Mr. Chairman, let me commend you for what I think is a very excellent job you are doing and especially in your approach to take a balanced approach to any regulatory efforts within the system. As you clearly know, one size does not fit all in this. It is my understanding that there are discussions within the Commission about trying to determine whether ethanol falls under the agricultural commodity category and all the limitations that applies, or whether it qualifies as an exempt commodity that could be traded under an exempt commercial market that currently receives a higher level of regulation. Where does that discussion stand now and how soon would this determination be made concerning ethanol?

Mr. LUKKEN. Again, to highlight my colleague, Mike Dunn, who is holding this Agricultural Advisory Committee in early December,

this is on the agenda to talk to producers, different stakeholders in this area to find out, as you properly note agriculture must be agricultural products, have additional protections, must be traded on the full designated contract markets, where as energy products may be able to trade on these lighter-touch exempt commercial markets. Where ethanol falls, whether it is agriculture or energy we have really not been faced with having to make that determination but it is something we are going to have to resolve. So the first step is to have a hearing on this to talk to the stakeholders, and then internally debate where we need to go and, hopefully, in short order come up with an answer.

Mr. SCOTT. How soon do you think that will be?

Mr. LUKKEN. Well, the hearing is in December so we can, certainly, by first of next—first quarter come up with an answer in this area.

Mr. SCOTT. Okay. My other question, as you know that legislation has been introduced in the House to give the CFTC authority and a directive to collect trading information on energy-based derivatives from the entire OTC market on a regular basis. Assuming that that were to take place, how much information would be coming to the CFTC? Does your agency now have adequate staff levels to sort through this data? And how helpful would this information be in the agency's efforts to detect manipulation given the nature of derivatives traded on the over-the-counter market?

Mr. LUKKEN. Congressman, the bilateral energy markets are enormous. You know, as we thought about this issue during our study last month, a lot of these transactions are individually negotiated, non-standardized contracts so for us to receive this type of information from a very large market and a non-standardized forum, it is very difficult for us to extrapolate information that is meaningful from a regulatory point of view. Having said that and, certainly, as you mentioned it would take an enormous amount of staff time and resources to do that, currently which we don't have, having said that, that doesn't mean that the bilateral markets aren't in some ways useful on an ad hoc basis to get information from. And, in fact, today we came out with regulation 1805, which was finalized, which allows us when we see problems in the regulated marketplace to be able to go after information in the bilateral markets that may help us explain the entire picture of what may be going on in regards to certain traders. To use that is the most effective approach. It is regulating the designated contract markets and ECMs when they are serving a significant price discovery role, and then also complementing that with being able to go after certain information in the bilateral markets on a need-to-know basis.

Mr. SCOTT. All right. Ms. Williams, right quick, time is running out, but the CFTC put out a report stating its contention that natural gas prices changes from August 2003 through August 2004 were not significantly affected by the trading activity of managed-money traders. As part of your review, you examined that report. Did you find any flaws in that report and what would you characterize in its findings as accurate?

Ms. WILLIAMS. I think in terms of specifically what CFTC looked at we didn't necessarily find significant issues with the report and what we tried to do in our report was kind of broaden the scope

of research on this particular issue. So it was a narrowly focused report and I think for that purpose we didn't find any significant issues.

Mr. SCOTT. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Texas, Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman.

Mr. Lukken, following along with Jerry Moran's questions on the significant price discovery process, the volume issue that the number of contracts or dollar values have, what would that be in terms of your threshold?

Mr. LUKKEN. That has not been fleshed-out but, initially you would have to be in some relationship to the market that we are looking at, some percentage of the market we are looking at so it could be either in dollars or volume of trades.

Mr. CONAWAY. Okay. And on the, help me understand, you said there was some link between that price discovery and other commercial activities that is going on whether that price is referenced. How would you gain that information or what do you mean by that?

Mr. LUKKEN. Well, this would be something we would have to work with this Committee and the industry to develop. It could involve and some, certainly, some of these products are so large that we just know about them from surveilling the regulated market. But this may involve us having to go out and talk to people in the industry to determine how people are referencing these products. You know, in starting to develop a standard, we have to make sure that it is concise, that it is predictable, that it is cost-effective for us and the industry to implement.

Mr. CONAWAY. Yes. Would you develop these standards based on some sort of a rules process where you would put out the proposed way you would do this and have the industry respond?

Mr. LUKKEN. That would be one way to do it if this Committee directed us to do that, yes.

Mr. CONAWAY. All right. With respect to foreign exchange fraud, can you give me a sense of what the estimated dollar fraud is in any 1 year of losses?

Mr. LUKKEN. Let me turn to my enforcement sheet here. Yes, the best we can do is there is about a billion dollars of penalties that we have recovered over the last 5 years in this forex.

Mr. CONAWAY. And the penalties are related to the losses is that what it is?

Mr. LUKKEN. Well, some of it is restitution, which is customer loss, some of it is civil monetary penalties.

Mr. CONAWAY. Okay.

Mr. LUKKEN. So we can get you figures on restitution if that might narrow your——

Mr. CONAWAY. Well, I am just trying to figure out, because if that is what you have caught——

Mr. LUKKEN. Right.

Mr. CONAWAY.—and you have had complaints on then that is not 100 percent of the exposure.

Mr. LUKKEN. Probably not, no.

Mr. CONAWAY. Okay. Ms. Williams, you posed a series of really interesting questions at the end of your comments, and I am wondering should your study have answered those questions or should those be posed to the Commission and us ask them to answer? Who should be the best group or whatever to answer those really good questions?

Ms. WILLIAMS. I think some of them would need to be posed to the Commission, and I think some of them would need to be posed to a broader audience, and answered and addressed collectively. And I think our position in terms of posing the questions are these are some of the fundamental questions that need to be answered before you can come to policy decisions.

Mr. CONAWAY. Are these rhetorical? Did you all answer them for yourself? Do you already know the answers?

Ms. WILLIAMS. We don't.

Mr. CONAWAY. Oh, okay.

Ms. WILLIAMS. We don't.

Mr. LUKKEN. Can you share them with me?

Mr. CONAWAY. All right. Thank you, Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. I appreciate your testimony and appreciate the good work your staff does. It is a pretty impressive group of people and I know that you struggle with resources to keep up. Has there been any discussion at the staff level or among the Commissioners concerning sources of funding and whether or not fees should be, industry fees should be used in order to fund the CFTC?

Mr. LUKKEN. The Commission has not taken a position on fees. Obviously, the Administration has proposed in the past over the last 20 years putting a fee on this industry, a transaction tax. We are one of the only financial agencies that currently does not have a fee. I always feel more comfortable talking not about how the money is collected but how you do spend it and, certainly, the need is there to spend it, and whether it is appropriated or a fee we, certainly, as an agency need appropriate funding to meet this Committee's mandate.

Mr. MARSHALL. The Committee heard testimony earlier this year about assertions from different individuals that energy prices were—speculation in energy prices caused them to lose quite a bit of money as they placed, you know, they tied in their future needs with contracts. Specifically in Georgia, Municipal Gas Authority of Georgia locked in prices in October and believes very, very fervently that amorous speculation was largely the reason why it wound up losing millions and million of dollars. In the suggestions that you have made for amending the CEA in reauthorization, would the problems that they have identified or at least they believe exist be addressed or is your proposed amendment to the CEA sort of silent on that question?

Mr. LUKKEN. I think it directly addresses their concerns. First off, I think the contract that they were referencing was this ICE–NYMEX look-a-like contract that interacts together.

Mr. MARSHALL. So your suggestion is that the look-a-like portion of this where ICE would be required to manage the contract as

NYMEX would with position limits *et cetera,* would solve the problem somehow?

Mr. LUKKEN. Well, as you mentioned, the ICE would now be required to put in speculative limits on these contracts as they expire similar to how NYMEX currently does it. We would, also, have a view of the entire market now, where as before we only saw the NYMEX portion, we would now see ICE's traders as well as NYMEX's traders. I think another important point that came out—oh, I am sorry, go ahead.

Mr. MARSHALL. Let us assume that there is a position limit. Would an Amaranth-type character that is convinced there is a lot of money to be made here, then move into the bilateral market and largely have the same effect on the market overall despite the position limit?

Mr. LUKKEN. Well, the bilateral market does not serve significant price discovery function so in your case where your constituent was pricing off of ICE or pricing off of NYMEX, they would not be pricing off the bilateral transaction.

Mr. MARSHALL. But doesn't the bilateral market, huge as it is, large trading on the bilateral market inevitably is going to have an impact on the kind of trading that occurs on-exchange.

Mr. LUKKEN. Correct, but it all has to come on-exchange at some point and that is when we see it. That is when we will see it on ICE, and we will see it on NYMEX.

Mr. MARSHALL. And so what do you do when you see it?

So you know that there is a big move being made by somebody, how do you—and how do you determine that that somebody is making a mistake, and that that somebody needs to be reined in, or an awful lot of people who are just sort of caught in this tempest are going to be hurt.

Mr. LUKKEN. Well, oftentimes, I mean this is what our surveillance economists do. They have been doing this for 30 years. They call up these types of traders that they see with positions that concern them. They ask them what their economic justification might be for doing this.

Mr. MARSHALL. Would you be in a position to simply tell Amaranth to stop?

Mr. LUKKEN. To stop?

Mr. MARSHALL. Buying, pushing price up.

Mr. LUKKEN. Certainly, at certain levels, yes, our emergency authorities allow us to halt trading, liquidate trading, spec-limits will prevent them from getting into a position that could——

Mr. MARSHALL. Even if you—don't you—isn't that because you have authority to control manipulation, and their response would be, "No, we really do think this is what we need to do because that is what is going to happen to market."

Mr. LUKKEN. Well, their speculator position limits are hard limits, so they would have to get out whether we think it is manipulation or not. It is a rule violation so that is not something subject to interpretation.

Mr. MARSHALL. Mr. Chairman, I see my time is up. I think we need to do a little bit more work on this to fully understand whether or not the changes that have been proposed will have the effect

of calming the oscillations that we have seen as the result in part of major speculation in energy markets. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman, and I would say to him I am not sure we ever knew what speculation was, we got people.

The gentleman, Mr. Walz.

Mr. WALZ. Thank you, Mr. Chairman. And thank you, Mr. Lukken, just one quick question here and it may be more of an observation on this. This forex question continues to come up, come up and come up. We hear a lot of concerns and questions from this. I guess, my question on this, is this a relatively new product to the American consumers, and these products have been in other parts of the world, I am thinking Asia in particular, has been relatively popular. I think the number I hear is 40 percent of Japanese citizens own this as part of their portfolio. It is pretty well-established, pretty well-regulated in the UK and in Hong Kong, and my question is as this being a product that consumers obviously want and the numbers are going up there, are we working to figure out a way to get the correct amount of regulation on this? Or, are we just continuing to see this as a nuisance product that is embedded with fraud when I don't think a lot of the other markets see that? I would be interested to hear your opinion.

Mr. LUKKEN. I think you make very good points. We have to make sure that we strike the right balance of giving proper regulation to this product. If there is a legitimate demand by consumers in the United States for it that it is properly overseen, that the capital requirements on the firms offering it are adequate enough to ensure that fraud is not going to occur. So we are trying to strike that balance of making sure there is enough regulation, but also not too much regulation that you put legitimate firms out of business.

Mr. WALZ. And is CFTC the right place for that to happen, in your opinion, or is that the only place for it to happen?

Mr. LUKKEN. Well, traditionally we have, because these are futures transactions, we have expertise in this area. We have lots of experience enforcing forex problems so I think we have the right expertise to police the markets.

Mr. WALZ. Thank you. I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from the Dakotas, Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman.

First of all, I want to note that attending the hearing today is Commissioner Chilton. He has previously served on the staff of House Agriculture Committee Members Jill Long and yours truly before going to the Senate where he worked for among others Leader Daschle. So I think it is very—we have a welcome addition to the Commission ranks to have someone that really so fully understands agriculture policy as seen by legislators, and I was very delighted with that particular appointment. Also, pleased to have a Commissioner sitting in on the whole hearing to get a sense for what we are wondering about.

A question I would have is and I am in the middle of a Ways and Means markup and forgive me if it has been asked already. But I am interested in how CFTC has involved itself in the review

of financial regulatory structures the Treasury has been conducting?

Mr. LUKKEN. As a member of the President's Working Group we——

Mr. POMEROY. I meant conducting through the President's Working Group.

Mr. LUKKEN. Yes, this is not an issue before the President's Working Group formally. This is under the leadership of Secretary Paulson who has asked as series of 30 questions about the regulatory structure in the United States. I would note, and that he is trying to figure out what is the best system for U.S. competitiveness going forward. I would suggest that you should look at the competitive advantage of the U.S. futures industry. The fact that we are leaps ahead of others in gaining market share around the world. So we are engaged on this issue. One of the questions deals on principles-based regulation and whether the entire financial services sector should go under a principles-based system. I am here to say yes, that it has worked very well for this agency and for this market in general and allowed us to be flexible in a global marketplace.

Mr. POMEROY. Help us understand that. What is that really? What is a real-life context in terms of a principles-based structure?

Mr. LUKKEN. Well, oftentimes we will, through different acceptable practices, lay out what we expect of market participants. However, they may come up with a new way of doing something, a new way of trading or a new way of trying to conduct business. They could come to us and say, "Look, it doesn't meet the specific rules that you have laid out for us, but we think in general it meets the principles that you have set out in principle 5. So allow us to do this knowing that." So on the margins you allow for innovation. Those that want the safe harbor of the acceptable practice and knowing for certain that they are in compliance can stay within the four corners. But if those that want to innovate can help step outside of that and develop new best practices that others in the industry may abide by as well. So it has proven very effective for us and is really made the relationship between industry and the regulator something that is informal that they come to us early in the process if they have ideas and changes so that we are able to know what is coming down the pike *versus* doing something that is sort of "gotcha" form of regulation.

Mr. POMEROY. I have been puzzling a lot with this whole subprime business about innovation *versus* transparency. We have had things that are so newfangled no one knows what the hell they are buying or investing in. How do you parse that one?

Mr. LUKKEN. Well this is a bit out of the CFTC's lane but these are very complex instruments and part of the problem is we didn't know the amount of exposure of a lot of these types of instruments out there. I would say from a futures specific perspective, the markets have been very helpful. A lot of the re-pricing has been done in the futures markets themselves. From this August to last August trading volume is up 90 percent. So that is a sign that people are utilizing the futures markets in order to re-price this risk where there is liquidity and that is helping us to get through this transition.

Mr. POMEROY. I don't have enough time to pursue that. I might call you for further information.

Mr. LUKKEN. Yes, sir.

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

The CHAIRMAN. I thank the gentleman.

I just have two quick questions to get on the record before we close and the Ranking Member has one and then we will try to close before we go vote so we can finish this. As you know, Senator Levin has introduced legislation to amend the CEA with regard to regulation of exempt commercial markets that trade energy-based derivatives. I would like to hear a comparison between that bill and your recommendation how the triggers for regulations differ, and how does the scope of regulation and regulatory requirements that could be imposed upon, to see if the instruments compare. Can you give us a quick answer to that?

Mr. LUKKEN. Well, Senator Levin has provided, obviously, valuable leadership in this area and it was before his Committee that we committed to take a closer look a few months back at this issue. As far as the trigger I think Senator Levin's bill also looks at significant price discovery as a trigger. They do have a few things differently. They look at the entire marketplace *versus* a product by product determination for us, and there are many other different things that may differ but, certainly, the general intent of looking at these markets and ensuring that they are properly policed, we are the same with Senator Levin and with our proposal. We would be happy though to provide a side-by-side.

The CHAIRMAN. Would you, please, do that for the Committee?

Mr. LUKKEN. Yes.

The CHAIRMAN. I appreciate that.

Mr. LUKKEN. We will have our——

The CHAIRMAN. If you would get it to us in writing.

Mr. LUKKEN. Sure.

The CHAIRMAN. Thank you.

Ms. Williams, I have in my hand a new colleague from one of our House colleagues in support of H.R. 594, Prevent Unfair Manipulation of Prices Act. It says that GAO is essentially calling to implement the policy recommendation proposed by this Act. First question in conducting this review, did your group examine the policy recommendations of H.R. 594? Can you describe for us the provisions of H.R. 594 or should anyone reading this report, take it as an endorsement of H.R. 594?

Ms. WILLIAMS. I would be more than happy to provide an official response for the record.

The CHAIRMAN. Would you, please?

Ms. WILLIAMS. But in terms of our report we didn't take a position on any particular pending legislation or policy positions, but I will provide a response.

The CHAIRMAN. Would, you please? Thank you, ma'am.

Ms. WILLIAMS. Absolutely.

The CHAIRMAN. I yield to the Ranking Member.

Mr. MORAN. Mr. Chairman, thank you.

Mr. Lukken, in—you talk about the intermediated transactions and the 7th Circuit Court of Appeals decision, have other venues

cited the 7th Circuit Opinion? Are you encountering enforcement problems as a result of that, and the CFTC's response?

Mr. LUKKEN. Absolutely, other circuits are starting to reference the *Zelener* decision and starting to adopt its findings. And so that is the recent court cases that I referenced in my testimony that we are having problems as a result of that. So that is why it is imperative that this Committee, hopefully, take a close look at this and pass something soon.

Mr. MORAN. So has *Zelener* become the law?

Mr. LUKKEN. It is not the law in all circuits but others are beginning and it seems to be picking up momentum that other courts are beginning to reference it and adopt those findings.

Mr. MORAN. I can't remember from our earlier testimony and hearings on this topic, has any court of equal standing rejected *Zelener*?

Mr. LUKKEN. It seems to me that there was a Second Circuit, oh there was a finding in the 6th Circuit but it is currently pending on appeal.

Mr. MORAN. Okay. Thank you very much.

Ranking Member Goodlatte has additional questions he would like to submit to our witnesses in writing.

The CHAIRMAN. Without objection.

Mr. MORAN. Thank you.

The CHAIRMAN. Just before we close, Mr. Marshall would like to finish up on one of the pieces before we close out. I would recognize the gentleman from Georgia.

Mr. MARSHALL. Thank you, Mr. Chairman.

Chairman Lukken, we were talking about an Amaranth-type situation where people are convinced that as a result of the speculation of a very large trader the markets been moved inappropriately to the detriment of an awful lot of people who necessarily have to rely upon that market to cover their future positions and let us just assume that that can happen and let us assume that we would like to do something about it. You are suggesting that the proposed changes would have that effect because where there are like contracts and in this—in the Amaranth situation there were, ICE would now be acting pretty much as NYMEX where position limits are concerned. The question is you have this large trader that is convinced that it is in their financial interest to take these positions, now it can't take as much of a position on ICE as it did in the past, doesn't it move to the bilateral market or move overseas or something like that and effectively have the same impact upon the market and I understood you to say, "Well, no, because we are in a position to stop that." I would like to know how you go about doing that. It would be comforting to a number of people that are quite concerned about the problem.

Mr. LUKKEN. Let me clarify. I think for us when we looked at this problem, again the Commodity Exchange Act the key determinate for regulation is price discovery and that is when people are able outside the markets to reference these prices. In the bilateral markets, no one is referencing off of private transactions that may be individually negotiated. Certainly, as you correctly point out these may influence the regulated marketplace but I think as we are looking to find consensus on this. There was not consensus that

due to cost considerations of collecting data and trying to fit these individually in negotiated transactions into a regulated system, the marginal benefits that might develop.

Mr. MARSHALL. So I misunderstood you, I thought you suggested that if you discovered this was going on by an Amaranth-type, hypothetical character, you could tell them to stop.

Mr. LUKKEN. If we saw something on a regulated exchange we could through our regulation 1805 authority ask them to stop their activity on the regulated exchanges, ask for additional information of what they are doing in the bilateral markets as well, so that you could see the entire picture.

Mr. MARSHALL. But you could not stop them?

Mr. LUKKEN. Not in the bilateral markets.

Mr. MARSHALL. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

Ranking Member, do you have additional?

Mr. MORAN. No, sir.

The CHAIRMAN. Let me thank our witnesses for being with us today. You have been very helpful and I appreciate it. Under the rules of the Committee, the record of today's hearing will remain open for 10 days to receive additional materials and supplemental written responses from witnesses to any questions posed by Members of the panel. This hearing on the Subcommittee on General Farm Commodities and Risk Management is adjourned.

[Whereupon, at 2:35 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED QUESTIONS

Responses from Hon. Walter Lukken, Acting Chairman, Commodity Futures Trading Commission, Washington, D.C.

Questions from Hon. Bob Etheridge, a Representative in Congress from North Carolina

Question 1. Regarding the President's Working Group (PWG) suggested language to correct the ruling in the *Zelener* case, has the current Commission taken another look at the language to determine its adequacy. If not, do each of the current Commissioners believe the proposal is adequate or does any of them believe it should be modified in some way; and, if so, how?

Answer. The Commission believes it is necessary to resolve the *Zelener* issue. The current Commission has not revisited this issue since 2005, when the House approved the PWG proposed *Zelener* language. The Commission as a whole has never opined on the proposed PWG language. As I testified at the September hearing, I believe it is critical to resolve the *Zelener* issue and that the PWG language is an appropriate solution. At least two Commissioners now believe that a broader fix would be appropriate.

Question 2. As you know, Senator Levin has introduced legislation to amend the CEA with regard to regulation of exempt commercial markets (ECMs) that trade energy-based derivatives. I want to hear a comparison between that bill and your recommendations. Please provide a *detailed* side-by-side comparison.

Answer. Senator Levin's bill (S. 2058) and the Commission's recommendations are directed to the same goal, though there are several differences in approach. For example, the triggers in Senator Levin's bill and the Commission's recommendations are generally similar—each looks to whether a significant price discovery function is being performed. But the Commission's approach keeps the CEA Section 2(h) framework for ECMs in place, with targeted add-on provisions for significant price discovery contracts in exempt commodities. Senator Levin's bill, by contrast, would establish a new category of registered trading platform for facilities trading price-discovery energy commodity contracts, which would be separate and apart from the ECM trading platform for other exempt commodities.

The consequences that result from a finding of a significant price discovery function also differ. Under Senator Levin's bill, trading facilities that meet the price discovery test would be subject to 17 Core Principles. By contrast, the Commission's recommendations focus on four key authorities: (1) large trader position reporting; (2) position limits and/or accountability levels; (3) self-regulatory oversight; and (4) emergency authority. This measured approach will preserve the role of ECMs as incubators for start-up markets and concepts, which several witnesses at our recent hearing said spurs competition and innovation.

Finally, Senator Levin's bill calls for record keeping and reporting obligations with respect to U.S. screen-based trading in energy contracts listed on foreign boards of trade. The Commission has not made any similar recommendations, which are problematic in today's global marketplace. They also are unnecessary given the effectiveness of the Commission's recently-adopted Policy Statement regarding screen-based trading in contracts listed on foreign boards of trade.

Although these differences in approach make a precise side-by-side analysis difficult, a chart comparing Senator Levin's bill and the Commission's recommendations in general terms is attached.

Question 3. Under CFTC Rule 36.3, exempt commercial markets must provide price, quantity, and other data on contracts that average five or more trades a day over the most recent quarter for which they are relying on the Commodity Exchange Act's exemption for these markets. The GAO report cites CFTC officials who say the agency does not actively check to determine whether that five or more trades a day threshold is being met on those exchanges that are relying on the CEA exemption but not providing information to the CFTC. Why isn't the CFTC conducting more checking to see if contracts on those markets are meeting the five a day threshold? Does an ECM have a responsibility in this area? What are the consequences, if any, to an ECM that fails to notify the CFTC that a contract has crossed the threshold?

Answer. GAO is correct. The Commission does not have a regular rule enforcement review program in place to check ECMs for compliance with the five-trade per day reporting requirement. However, there are safeguards in place to ensure ECM compliance with this provision. First, Regulation 36.3(b)(1)(ii) itself places an affirmative obligation on ECMs to notify the Commission when they have a contract that exceeds the threshold. Second, Regulation 36.3(c)(4) requires each ECM to file an annual certification with the Commission that it is continuing to operate within the conditions of its exemption from having to register as a designated contract market

(DCM). The terms of the Commission's ECM annual certification form make clear that these conditions include apprising the Commission of those contracts that meet the five-trade per day threshold.

Finally, the consequences of failing to properly notify the Commission of a triggering of the reporting requirement are extreme—there is a strong incentive for ECMs to honor this provision. ECMs that fail to apprise the Commission that they have triggered the reporting requirement run the risk of losing their exemption from DCM registration and expose themselves to a Commission enforcement action for operating an unregistered exchange pursuant to Section 4(a) of the CEA, for failing to comply with the reporting requirement of Regulation 36.3(b)(1)(ii), and, likely, for making a false statement in a filing required under the Commission's regulations pursuant to CEA Section 9(a)(3).

Question 4. Assuming the PWG *Zelener* language became law, what *specific sections* of the Commodity Exchange Act—if any—would prevent someone from using the same *Zelener*-type contract but for natural gas, corn, wheat, or another commodity besides forex?

Answer. The Commodity Futures Modernization Act of 2000 (CFMA) authorized off-exchange trading by retail customers only in foreign currency futures and options. It did not change the law for commodities other than foreign currencies. Thus, off-exchange futures trading activity involving retail customers in any other commodity (such as natural gas, metals, corn, or wheat) remains illegal under CEA Section 4(a), which prohibits off-exchange trading in futures.

Thus far, we have not seen the *Zelener* contract form, which the 7th Circuit held to be a spot contract, utilized for commodities beyond foreign currency. Further, the best means to address the *Zelener* issue—striking the necessary balance between cracking down on fraudsters while not interfering with legitimate businesses—may vary depending on the commodity involved. Accordingly, I believe that it is best to address the problem that is presently before us and that has been before us for the past several years—foreign currency.

Question 5. The CFTC Reauthorization bill from last Congress would have required introducing brokers to register with the National Futures Association (NFA). In his testimony last month, Mr. Roth, President of the NFA proposed to expand this to include commodity trading advisors (CTAs) and commodity pool operators (CPOs). Can you talk about whether CTAs and CPOs current are registered with any regulatory body and whether the Commission thinks we need to require their registration with the NFA?

Answer. The CFMA specified certain categories of entities that may act as counterparties to customers for off-exchange retail forex transactions. However, the CFMA was silent with respect to intermediaries for such transactions and provided that most of the CEA does not apply to such transactions. Thus, entities that act in a manner similar to that of introducing brokers, CPOs or CTAs with respect to these forex transactions are not required to register, as would be the case if they were intermediating exchange-traded transactions. The registration requirement in the proposed forex amendments submitted by the PWG and included in the Reauthorization bill passed by the House of Representatives in December 2005 was not limited to introducing brokers. It would require registration of any person who participates in the solicitation or recommendation of off-exchange retail forex transactions.

Question 6. Please provide the Subcommittee with a record of total dollar amount of fines levied by the Commission for each year starting with 2000. Please do likewise for the total dollar amount of fines actually collected.

Answer.

Civil Monetary Penalties FY 2000–2008

Fiscal Year	Penalties Imposed	Penalties Collected
2000	$179,811,562	$3,299,362
2001	$16,876,335	$3,170,252
2002 [1]	$9,942,382	$5,922,387
2003	$110,264,932	$87,699,077
2004	$302,049,939	$122,468,925
2005 [2]	$76,672,758	$34,237,409
2006	$192,921,794	$12,321,530
2007	$327,378,507	$11,897,033
2008 [3]	$126,045,682	$4,835

[1] Includes $30,005 for civil monetary penalties imposed in prior years.

[2] Includes $617,409 for civil monetary penalties imposed in prior years.
[3] Through October 2007. Pending $125,000,000 BP Settlement Collection.

The discrepancy between the amount of civil penalties imposed and the amount collected is accounted for by the following factors: (1) when courts order the defendants to pay both restitution to victims and a civil monetary penalty to the Commission, established Commission policy directs available funds to satisfy customer restitution obligations first; (2) in fraud actions, it is not uncommon that the proceeds of the fraud have been dissipated and/or that the penalty far exceeds the defendants' represented financial ability to pay; (3) penalties assessed in default proceedings against respondents who are no longer in business and who cannot be located or are incarcerated; (4) penalties imposed in 1 year may not become due and payable until the next year; (5) a penalty may be stayed by appeal; (6) some penalties call for installment payments that may span more than 1 year; (7) penalties have been referred to the Attorney General for collection; and (8) collection still in process internally.

Question 7. If the Commission were allowed to keep 10% of the fines its actually collects to fund IT upgrades, modernization, and improvements, would that make a significant difference in improving the CFTC's IT infrastructure—assuming there are no corresponding reductions on the appropriations side?

Answer. Assuming there were no corresponding reductions on the appropriations side, any funds from penalties collected would improve our fiscal situation. In Fiscal Year 2006, we collected over $12 million in penalties, which (assuming the Commission retained 10%) would translate roughly into $1.2 million. This amount would not fully fund our IT requirements, but would provide much needed fiscal relief.

Questions from Hon. Bob Goodlatte, a Representative in Congress from Virginia

Question 1. The CFTC report recommends that if an Exempt Commercial Market (ECM) has a significant price discovery function it should have position limits imposed on it. Would the policy on position limits on ECMs be similar to the policy on Designated Contract Markets (DCM) with limits on speculative trades, reduced limits near expiration and review or exemptions of positions held in excess of the limits for legitimate hedges? Would the imposition of position limits on ECMs stifle in any way the creativity offered by ECMs?

Answer. We anticipate that ECMs would be subject to the same type of accountability-level/position-limit regime that is currently required of DCMs under DCM Core Principle 5, including the availability of hedge exemptions and spot-month position limits where appropriate. Accordingly, ECM contracts that became subject to such an accountability-level/position-limit regime would be treated in a similar manner to comparable DCM contracts under DCM Core Principle 5.

As with any regulatory restriction, there is a possibility that position limits may impact ECM operations. However, the Commission's recommendation that an accountability-level/position-limit regime be imposed on ECM contracts that perform a significant price discovery function is a very discrete measure. This high standard has been carefully chosen to ensure that there are minimum safeguards in place to prevent the manipulation of contracts that could have a very real impact on the prices of commodities in interstate commerce—a goal that underpins the CEA and the statutory mandate of the CFTC.

Question 2. If a contract trading on an ECM is deemed to provide a significant price discovery function, by what mechanism would the authority you are requesting be effectuated?

Answer. We would anticipate that any amendments to the CEA that require additional obligations of ECMs when they list contracts that become significant sources of price discovery would themselves include rulemaking authority for the Commission to establish standards and procedures for making such determinations and for effectuating the authorities that result from such a determination. These rules also would set forth the specific procedures and guidelines that the Commission would follow in making such determinations. The Commission in establishing such standards and procedures would attempt to ensure that they had a high degree of objectivity, thus minimizing any legal uncertainty for ECM operations.

Question 3. Additionally, who would make the determination that a contract trading on an ECM is serving a significant price discovery function? Over what time frame would you see the determination being made that a contract trading on an ECM is serving a significant price discovery function and that the additional authority needs to be implemented on this contract?

Answer. We would anticipate that the Commission would be given the authority to make determinations as to whether ECM contracts are serving a price discovery function. We also anticipate that any price-discovery determination would be based

upon a contract's behavior over some reasonable length of time, as the Commission would want to avoid a situation where contracts are moving in and out of price-discovery status.

Question 4. Last year the Commission testified that the changes proposed in Title II of H.R. 4473 (the CFTC reauthorization bill in the 109th) specific to natural gas price transparency were not necessary. Has the Commission changed its position?

Answer. We appreciated the bipartisan efforts of this Committee during the 109th Congress to address consumer concerns over volatility in the natural gas markets. The measures recommended in the Commission's ECM Report strike an appropriate balance in the regulatory approach to these issues. As indicated in the Report, we do not see a need to impose added regulatory requirements on over-the-counter (OTC) bilateral energy contracts. A targeted approach to ECM significant price discovery contracts will best address the regulatory concerns that have been raised while still allowing ECMs to serve as a venue for start-ups where innovative trading ideas can incubate and be tested.

Question 5. What type of self-regulatory structure does ICE currently have?

Answer. Currently, ICE, as an ECM, is not required by the CEA to have any oversight structures commonly associated with a self-regulatory organization such as a DCM.

Question 6. If an ECM and the CFTC were provided with emergency authority over a contract what could either do if fraud or manipulation were suspected or detected?

Answer. Historically, the futures exchanges and the Commission have possessed broad authority under the CEA to address market emergencies. Under Section 8a(9) of the CEA, in an emergency, the Commission can require an exchange "to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading" in a contract. This broad authority would permit the Commission to impose trading limits, or even require liquidation, to restore orderly trading conditions in the marketplace. Similarly, Core Principle 6 of the CEA requires that DCMs adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, including the authority to liquidate positions and suspend trading where necessary and appropriate. Having these emergency authorities available often enables Commission and exchange staff to work with market participants to prevent emergency situations from arising in the first instance. We would anticipate that these same authorities would apply to significant price discovery contracts traded on ECMs.

Question 7. I, too, think the penalties under § 9 should be increased to reflect the severity of the crime. Instead of limiting penalties to $1 million, why not make the sanction a factor of the illegally obtained profit? Perhaps we should allow for treble damages (Three times the amount of damage a judge/jury found the defendant to cause) like antitrust law calls for.

Answer. In addition to CEA Section 9, Sections 6(c) and 6c of the CEA currently provide for penalty authority of "not more than the higher of $100,000 [adjusted to $130,000 to account for inflation] or *triple the monetary gain*," whichever is higher. Accordingly, the CEA already contemplates the possibility of penalties based on illegally obtained profits, including treble damages.

Question 8. You have testified, stated in press accounts, and told me in conversation that CFTC staffing levels have hit an all time low. In the 2000 modernization effort we authorized pay parity for the CFTC. How has this affected your staffing levels?

Answer. Exempting the CFTC from Title V and authorizing pay parity with the FIRREA agencies has been crucial to recruiting and retaining professionals needed to oversee the complex futures markets. The Commission has implemented pay parity with funds appropriated by Congress. Since authorization, the Commission has, when necessary, sought funds to ensure that our pay structure and pay ranges are in line with the FIRREA agencies—and we are satisfied that they are.

However, presently at the Commission, staffing levels are at an all-time historic low, and employee turnover has returned to the double-digit levels we had experienced prior to exemption from Title V. In the last 2 years, the Commission has lost over 100 employees, most of which were retirements of senior professionals. We need to improve in our ability to recruit, promote, retain, and reward good performers within the existing pay structure—and additional funds have been requested in FY 2009 for this effort.

Question 9. If the Commission does not receive an increase in its appropriation, can the Commission augment its budget by imposing/increasing registration fees or assessments on trades?

Answer. The Commission has the authority to collect a number of fees related to our regulatory functions, such as contract market rule enforcement reviews and contract market designations. We have not interpreted this authority to extend to assessments on trades. The fees that we currently are authorized to collect are deposited in the General Fund of the U.S. Treasury.

Question 10. What happens to the money collected through the Commission's enforcement activity?

Answer. Funds collected from civil monetary penalties in CFTC enforcement actions are deposited in the General Fund of the U.S. Treasury. Funds collected from orders of restitution and disgorgement are distributed to injured victims.

Question 11. Last month this Subcommittee received testimony that securities and futures should be regulated in a consistent manner. Do you care to comment?

Answer. We support the notion of regulating securities and futures in a consistent manner wherever possible, and over the past several years the Commission has taken several steps to align our requirements with those of the SEC where that makes sense.

But it must be remembered that these are different markets—the SEC regulates markets whose primary function is capital formation, whereas the CFTC regulates markets whose primary functions are price discovery and risk management. Sometimes, the different functions of the markets, and the correspondingly different statutory mandates of the SEC and CFTC under the securities laws and the CEA, require different approaches by the two agencies.

For example, in the securities world, there are extensive disclosures required by the issuers of securities, i.e., public companies. In the futures markets, there are no "issuers." The mandated disclosures to retail futures customers thus focus upon the risks common to all futures trading.

Question 12. GAO testified that the Commission should more accurately report trading data for commercial *versus* non-commercial trades. The GAO highlights instances where commercial entities may actually place speculative trades but these trades are reported as commercial because the entity is a routine commercial trader. As a practical matter, can this be done given that entities are organized in any number of business units, they place trades in a variety of ways, and often establish proprietary methods for managing their company's risk? This would make standardizing the reporting in the manner recommended by GAO very difficult. What kind of problems can this detailed reporting create? What would happen if you reported with this type of specificity?

Answer. Using current reporting methodology, this detailed breakout of speculative positions held by commercials is not possible. To accomplish this, it would probably be necessary to either (1) have every commercial firm set up a separate reporting account for speculative trading; or (2) report its positions directly to the CFTC (as opposed to the current large trader reporting system, where futures commission merchants report customer positions to the CFTC). Either of these changes would entail additional costs to traders. Yet, it is not clear that such a change would substantially improve the commitments of traders (COT) data, as we are not aware that there is a substantial amount of speculative trading by commercials.

The main issue that the CFTC has faced with COT reporting is that commercial swap dealers hedge OTC activity (including OTC commodity-index related activity) in futures markets. While this trading is hedging (i.e., it is to offset price risk), it is different than traditional hedging of underlying physical business.

Question 13. Given the global growth of risk management and the futures industry, what is the CFTC doing with international regulatory bodies to coordinate efforts to prevent fraud and manipulation across the globe?

Answer. The CFTC has a robust and long-standing international presence. We are an active member of the International Organization of Securities Commissions (IOSCO), which is a standard-setting body for securities and futures regulators. IOSCO coordinates regulators around the world to promote high standards of regulation, including surveillance and enforcement standards. Additionally, the CFTC has numerous enforcement arrangements to share information with our overseas counterparts and coordinate our enforcement actions as much as possible. In addition to the CFTC's 24 bilateral enforcement information sharing arrangements with foreign regulatory authorities, the CFTC also is a signatory to the IOSCO Multilateral Memorandum of Understanding that provides for the sharing of bank, brokerage, and client identification records among the international regulators. Most recently, the CFTC signed an MOU with the UK Financial Services Authority (FSA) in 2006 to share information on an on-going basis to help detect potential market abuses where contracts are linked by settlement provisions. Finally, this past October, the CFTC Division of Enforcement convened an international enforcement

meeting with commodity regulators including participants from Europe, Asia, and South America. The meeting was focused on detecting and enforcing against anti-manipulative conduct, with the goal of enhancing the ability of the CFTC and its fellow regulators to detect and deter misconduct affecting commodity prices.

Question 14. GAO has recommended the CFTC develop "meaningful outcome-based measures" to determine the agency's effectiveness. What type of improved measures have you explored? Has GAO provided you detailed suggestions on what "meaningful outcome-based measures" would be appropriate for an agency like the CFTC?

Answer. GAO's conclusions were derived primarily from the OMB PART review, which recognized that the effectiveness of an enforcement program is not easily measured. GAO suggested that "there are a number of . . . ways to evaluate program effectiveness, such as using expert panel reviews, customer service surveys, and process and outcome evaluations." The Commission has requested funding in the OMB FY09 budget in order to explore alternate means to evaluate the effectiveness of the program.

Question from Hon. Nancy E. Boyda, a Representative in Congress from Kansas

Question. In our hearing in late September, Mr. Damgard, President of the Futures Industry Association, in his written testimony asked this Subcommittee and the CFTC to study the state of competition among centralized trading platforms and clearing entities for derivatives products with an eye toward making sure the existing futures market structure is the best for serving our customers. Does the Commission have any plans to look into this matter?

Answer. Section 5b(c)(2)(N) of the CEA requires each derivatives clearing organization (DCO), unless appropriate to achieve the purposes of the CEA, to avoid (1) adopting any rule or taking any action that results in an unreasonable restraint of trade, or (2) imposing any material anti-competitive burden on trading. On an ongoing basis, the Commission reviews DCO rules and other actions for compliance with this provision. The Commission notes that this provision directs that competitive concerns be weighed in light of the other purposes of the CEA, such as maintaining the financial integrity of the markets. To date, the Commission has not identified an instance where a DCO has violated this provision. The Commission will continue to monitor DCO activity in this area.

Attachment

Senator Levin's "Close the Enron Loophole Act" S. 2058	CFTC Proposal significant price discovery contracts on ECMs
I. Energy Trading Facilities	*Analogous Provisions in CFTC Proposal Applicable to Significant Price Discovery Contracts on ECMs.*
Section 2(a) of S. 2058 amends Section 1a of the CEA	Section 1 of the CFTC proposal amends Section 1a of the CEA.
A. Adds definition of "energy commodity" as commodity	A. Adds definition of "significant price discovery contract" as agreement, contract, or transaction subject to proposed CEA Section 2(h)(7).
1. used as source of energy such as crude oil, gasoline, natural gas, and electricity, and	
2. results from burning of fossil fuel	
B. Adds definition of "energy trading facility"	Not applicable to CFTC proposal.
1. not a designated contract market ("DCM")	
2. facilitates the execution or trading of agreements, contracts, or transactions in an energy commodity AND	
a. facilitates the clearance and settlement of agreements, contracts, or transactions in an energy commodity; or	Not applicable to CFTC proposal.
b. the Commission determines performs a significant price discovery function for energy commodities listed on a trading facility or in the cash market. Factors for the CFTC to consider:	CFTC to determine whether contract performs a significant price discovery function. Proposed CEA Section 2(h)(7)(A)–(B).
(1) extent to which price of an agreement, contract, or transaction is derived from or linked to the price of a futures contract traded on a DCM	Similar provision in CFTC proposal. Proposed CEA Section 2(h)(7)(B)(i)(I).
(2) extent to which cash market transactions are directly based on the prices in the same energy commodity traded on the energy trading facility	Similar provision in CFTC proposal. Proposed CEA Section 2(h)(7)(B)(ii).
(3) the volume of contracts traded on the trading facility	Similar provision in CFTC proposal. Proposed Section 2(h)(7)(B)(iii).
(4) extent to which data is published after completion of transactions	Similar provision in CFTC proposal. Proposed CEA Section 2(h)(7)(B)(ii).
(5) extent to which arbitrage market exists between the trading facility and the DCM	Similar provision in CFTC proposal. Proposed CEA Section 2(h)(7)(B)(i)(II).
(6) other factors Commission deems appropriate	Similar provision in CFTC proposal. Proposed CEA Section 2(h)(7)(B)(iv).
II. Section 2(b). Oversight of Energy Trading Facilities	*Analogous Provisions in CFTC Proposal.*
A. Section 2(b)(1) of S. 2058 amends CEA Section 2(h)(3) to exclude "energy trading facility" from qualifying as an exempt commercial market in order to make clear that those facilities must comply with new CEA Section 2(j)	Not applicable to CFTC proposal.
B. Section 2(b)(2) of S. 2058 adds a new Section 2(h)(7) to the CEA. This	Not applicable to CFTC proposal.

Attachment—Continued

Senator Levin's "Close the Enron Loophole Act" S. 2058	CFTC Proposal significant price discovery contracts on ECMs
new section provides that notwithstanding any other provision of CEA, an energy trading facility and persons trading on an energy trading facility are subject to the new CEA Section 2(j)	
III. Section 2(c). Criteria for Trading Facility Registration	*Analogous Standards for Significant Price Discovery Contracts.*
1. New Section 2(j)(4)(A) requires a trading facility to have the capacity to prevent price manipulation, excessive speculation, price distortion, and disruption of the delivery or cash-settlement process	Adds proposed CEA Section 2(h)(7)(C)(ii) Core Principle applicable to significant price discovery contracts—ECM must have market surveillance, compliance, and disciplinary practices and procedures.
2. New Section 2(j)(4)(B) requires a trading facility to monitor trading to prevent price manipulation, excessive speculation, price distortion, and disruption of delivery or cash-settlement prices	Adds proposed CEA Section 2(h)(7)(C)(ii) Core Principle applicable to significant price discovery contracts—monitoring of trading to prevent market manipulation, price distortion, and disruptions of the delivery or cash-settlement process.
3. New Section 2(j)(4)(C) requires a trading facility to list contracts not susceptible to manipulation	Adds proposed CEA Section 2(h)(7)(C)(i) Core Principle applicable to significant price discovery contracts—not readily susceptible to manipulation.
4. New Section 2(j)(4)(D) requires a trading facility that facilitates clearance and settlement by a derivatives clearing organization ("DCO") must establish and enforce rules requiring financial integrity of contracts	Not applicable to CFTC proposal.
5. New Section 2(j)(4)(E) requires a trading facility to establish and enforce rules for obtaining information	Adds proposed CEA Section 2(h)(7)(C)(iii) Core Principle—ability to obtain information.
6. New Section 2(j)(4)(F) requires a trading facility to adopt position limits or accountability levels to reduce threat of price manipulation, excessive speculation, price distortion or delivery or cash-settlement process	Adds proposed CEA Section 2(h)(7)(C)(iv) Core Principle—position limitations or accountability.
7. New Section 2(j)(4)(G) requires a trading facility to adopt rules for emergency authority including to (i) liquidate open positions; (ii) suspend or curtail trading; and (iii) require market participants to meet special margin requirements	Adds proposed CEA Section 2(h)(7)(C)(v) Core Principle—emergency authority, including authority to (i) liquidate open positions, and (ii) suspend or curtail trading in contract.
8. New Section 2(j)(4)(H) requires a trading facility to arrange for daily publication of trading information	Adds proposed CEA Section 2(h)(7)(C)(vi) Core Principle—daily publication of trading information.
9. New Section 2(j)(4)(I) requires a trading facility to establish and enforce rules to deter abuse	Adds proposed CEA Section 2(H)(7)(C)(vii) Core Principle—compliance with rules.
10. New Section 2(j)(4)(J) requires a trading facility to establish rules for recording and safe storage of trading information	Not applicable to CFTC proposal.
11. New Section 2(j)(4)(K) requires a trading facility to establish rules about trading procedures for entering and executing orders	Not applicable to CFTC proposal.
12. New Section 2(j)(4)(L) requires a trading facility to insure compliance with the rules	Adds proposed CEA Section 2(h)(7)(C)(vii) Core Principle—compliance with rules.

13. New Section 2(j)(4)(M) requires a trading facility to disclose to the public and the Commission information about contract terms, trading conventions, financial integrity protections, etc.	Not applicable to CFTC proposal.
14. New Section 2(j)(4)(N) requires a trading facility to establish fitness standards for directors and members of disciplinary committees	Not applicable to CFTC proposal.
15. New Section 2(j)(4)(O) requires a trading facility to establish rules governing conflicts of interest in the decision making process	Not applicable to CFTC proposal.
16. New Section 2(j)(4)(P) requires a trading facility to maintain all business records for 5 years	Not applicable to CFTC proposal.
17. New Section 2(j)(4)(Q) requires a trading facility to avoid adopting rules that create an unreasonable restraint of trade or impose anti-competitive burdens on trading on the facility	Not applicable to CFTC proposal.
B. Criteria for Energy Trading Facilities—new section 2(j)(5) provides that an energy trading facility must continue to comply with all of the criteria in section 2(j)(4) to continue operation, and that violation of any criteria shall constitute a violation of the CEA.	Core Principles apply to ECMs trading significant price discovery contracts on an ongoing basis. Violations of the provisions of proposed CEA Section 2(h)(7) constitute violations of the CEA.
C. Position Limits and Accountability—new section 2(j)(6) directs the Commission 1. to ensure that the position limits and accountability levels that are established for energy trading facilities are on a parity with the position limits and accountability levels established for similar contracts traded on a DCM and applied in a functionally equivalent manner, 2. to take action as necessary to reduce potential threat of price manipulation, excessive speculation, price distortion or disruption of delivery or cash-settlement process, and 3. to obtain information from a trader regarding the trader's exchange and off-exchange positions.	Adds proposed CEA Section 2(h)(7)(C)(iv) Core Principle—position limitations or accountability. Also, amends CEA Sections 4g and 4i regarding recordkeeping and large trader reporting, and Section 8a regarding emergency authority, for significant price discovery contracts.
D. Criteria for Commission Determination—new section 2(j)(6)(D) specifies criteria the Commission or exchange may consider when determining whether to require a trader to limit, reduce, or liquidate a position including: 1. person's open interest relative to the total open interest 2. daily volume of contract 3. person's overall position in related contracts, including options, and the overall open interest or liquidity in the related contracts and options 4. potential for positions to cause or allow price manipulation, excessive speculation, price distortion, or disruption of delivery or cash-settlement process 5. person's compliance record 6. any justification provided by person for such position, and 7. other factors as deemed appropriate by Commission	Not applicable to CFTC proposal.

Attachment—Continued

Senator Levin's "Close the Enron Loophole Act" S. 2058	CFTC Proposal significant price discovery contracts on ECMs
E. Information for Price Discovery Determination—Section 2(d) amends other provisions of the CEA to enable the Commission to obtain information from an electronic trading facility or a derivatives transaction execution facility to evaluate whether the energy trading facility performs a price discovery function	Conforming amendment (d) amends Section 2(h)(5) to extend CFTC's special call authority for ECMs to obtaining information to make a significant price discovery determination. Also, significant price discovery determination process subject to CFTC rulemaking authority under proposed CEA Section 2(h)(7)(A).
IV. Section 3. Reporting of Energy Trades A. Section 3 of S. 2058 adds a new CEA section 2(K) which requires U.S. persons who trade certain energy contracts on a foreign board of trade ("FBOT") to keep records and to report large trades.	*Analogous Provisions in CFTC Proposal.* Not applicable CFTC proposal.
V. Antifraud Authority A. Section 4 of S. 2058 amends Section 4b of the CEA to clarify the CFTC's authority to bring fraud actions in off-exchange principal-to-principal futures transactions.	Analogous Provisions in CFTC Proposal. Outside scope of proposal regarding significant price discovery contracts trading on ECMs; CFTC supports including this provision as part of CFTC reauthorization.
VI. Commission Rulemaking A. Section 5 of S. 2058 requires the CFTC to issue proposed rules within 180 days regarding requirements for an application for registration for an energy trading facility. CFTC must finalize rule within 270 days.	*Analogous Provisions in CFTC Proposal.* Adds proposed CEA Section 2(h)(7)(A) requiring CFTC rulemaking to implement the provisions of this legislation.
VII. Conforming Amendments A. Section 2 of S. 2058 includes various CEA conforming amendments to provide a comparable degree of CFTC authority over operations of registered energy trading facilities as exists with respect to DCMs.	*Analogous Provisions in CFTC Proposal.* Adds conforming amendments to : CEA Sections (2)(a)(1)(A)—exclusive jurisdiction over significant price discovery contracts on ECMs; CEA Section 2(h)(4)(D)—remove existing significant price discovery function provision applicable to ECMs in light of new Core Principle in CEA Section 2(h)(7)(C)(vi) requiring daily publication of certain trading information; CEA Section 5c—issuance of CFTC interpretations regarding compliance with Core Principles, delegation of functions under Core Principles, violations of Core Principles; CEA Section 8a—authority to alter or supplement rules of the trading facility and to share information with the trading facility.

Responses from Orice M. Williams, Director, Financial Markets and Community Investment, U.S. Government Accountability Office, Washington, D.C.

Question from By Hon. Bob Etheridge, a Representative in Congress from North Carolina

Question. We have heard many complaints that natural gas futures contracts have increased in volatility due to the increased participation of speculators—or noncommerical traders—in these markets. However, according to GAO's report, the market that has seen the greatest increase in noncommerical traders in the past 3 years has been the crude oil market; and—interestingly enough—your report states that this market has experienced declining volatility during the same period. Can you account for this discrepancy, or—if not—does this not cast doubt on the argument that increase participation by speculators inevitably causes increased volatility?

Answer. As you point out, our analysis of the price volatility of futures contracts showed that crude oil volatility decreased, on an annual basis, from 2003 through 2006. At the same time, CFTC large trader data reveal that the average daily number of noncommercial traders in crude oil futures and options contracts grew from about 125 to about 286 from July 2003 to December 2006.

We agree that these trends are not consistent with assertions that increased speculation necessarily results in increased price volatility. However, it is important to note that while there may be a correlation between the two, causation is more difficult to prove empirically. Even if the number of noncommercial, or speculative, participants increased during a period of rapidly rising price volatility, there may be a number of factors contributing to such a trend. For example, speculative traders may be attracted to a market with high or increasing volatility because it increases the opportunity to profit from changing prices. Furthermore, natural gas historically has been more volatile than other energy commodities, and other commodities in general, due to difficulties in storage and transportation and sensitivity to changing weather.

Questions from By Hon. Bob Goodlatte, a Representative in Congress from Virginia

Question 1. What is a "meaningful outcome based measure" and how can it help the Commission identify violations or deter misconduct? What specific "outcome based measures" have you recommended to the CFTC? What are examples of "outcome based measures" that are used by other Federal agencies that would be applicable to the CFTC?

Answer. The Office of Management and Budget's (OMB) Program Assessment Rating Tool (PART) review of CFTC's enforcement program—which is the basis for much of our discussion—interprets a meaningful outcome based measure to be one that "fully reflect[s] progress on meeting the program's overall goals." [1] The purpose of outcome-based performance measures is to help the CFTC better assess and improve its performance in meeting program goals, including the identification of violations and deterrence of misconduct. As we note in our report, PART is meant to serve as a diagnostic performance tool, drawing on available program performance and evaluation information to form conclusions about program benefits and recommend adjustments that may improve results.

Our report did not recommend that CFTC consider any specific outcome-based measures. Rather, we note that enforcement agencies, such as CFTC, face challenges in developing meaningful measures. Therefore, we identified a number of other ways to evaluate the effectiveness of its enforcement program including the use of expert panel reviews, customer service surveys, and process and outcome evaluations.[2]

Question 2. What type of classification would you like to see in the reports issued by the Commission to eliminate the "disconnect" you noted in your testimony?

Answer. In December 2006, CFTC announced a pilot program to more accurately reflect the nature of positions held by nontraditional hedgers, such as swap dealers, in the COT report by including positions of commodity index traders in a separate category. We recommended that CFTC consider expanding this pilot (e.g., separate reporting category for commodity index funds) to include energy commodities. As currently structured, the Commitment of Traders (COT) reports for energy commodities make no distinction between commercial traders who use futures exchanges to hedge their positions in the physical markets and those commercial traders, such

[1] See p. 54 of our report; and 1181175, p. 9, 4.1.
[2] P. 56 of our report.

as investment banks, who trade futures to hedge their trading in off-exchange derivatives.

Question 3. Did you evaluate how the market oversight division and the enforcement division of the CFTC interact? If so, do you find there to be adequate interaction between the two divisions?

Answer. While we did not evaluate the extent of interaction, our report does describe how the market oversight division and enforcement divisions interact. For example, beginning on p. 44 of our report (GAO–08–25), we describe how CFTC can use information gathered from surveillance activities, especially on large traders, to identify unusual trading activity and possible market abuse. On page 48, we discuss how market oversight staff may refer instances of questionable trading activity to the enforcement division to conduct nonpublic investigations.

Question 4. In last month's hearing and again today we received testimony on the increasingly global scale of the futures market. Did you consider the likelihood that any of your recommendations—greater regulation, reporting requirement or enforcement activity—would potentially force this business overseas, beyond the regulatory reach of the CFTC?

Answer. Some industry observers we spoke with shared concerns that greater oversight could result in certain activities moving offshore. However, our matter for Congressional consideration (that Congress consider further exploring the adequacy of the current regulatory structure for energy derivatives) suggests that Congress further explore the currently regulatory structure. Any such consideration should include considering the global nature of the market and the impact regulatory changes may have on off-exchange markets. Similarly, our recommendations to CFTC should not directly affect market participants. For example, we recommend that CFTC reexamine the way it classifies the data it already receives from market participants in the COT reports *versus* new reporting requirements on market participants. Likewise, our recommendations on improving its monitoring documentation and evaluating its enforcement activities are both aimed at improving the operational effectiveness of CFTC's existing activities and requirements.