

**REAUTHORIZATION OF THE COMMODITY
FUTURES TRADING COMMISSION**

HEARINGS
BEFORE THE
SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT
OF THE
COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES
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REAUTHORIZATION OF THE COMMODITY FUTURE TRADING COMMISSION

WEDNESDAY, MARCH 3, 2005

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

The subcommittee met, pursuant to call, at 10:00 a.m., in room 1300 of the Longworth House Office Building, Hon. Jerry Moran (chairman of the subcommittee) presiding.

Present: Representatives Boehner, Lucas, Pence, Graves, Bonner, King, Musgrave, Neugebauer, Boustany, Etheridge, Salazar, Marshall, Herseth, Butterfield, Pomeroy, Boswell, Larsen, Chandler, Scott, Costa, and Peterson [ex officio].

Staff present: Brent Gattis, Dave Ebersole, Kevin Kramp, Tyler Wegmeyer, Debbie Smith, Jennifer Daulby, Alise Kowalski, Matt Smith, Rob Larew, John Riley, and April Dement.

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

Mr. MORAN. Good morning, everyone. This hearing of the Subcommittee on General Farm Commodities and Risk Management will now come to order. We are here today to review the Commodities Futures Modernization Act, and to see what has worked well, discuss what changes, if any, might need to be considered by our subcommittee as we proceed to reauthorize that legislation.

I am delighted today to have our witness, Dr. Sharon Brown-Hruska, who is the acting chairman of the Commodities Futures Trading Commission, and I am delighted that she is joining us.

Just a few opening thoughts, and then, we will hear from Chairman Hruska. The Commodities Futures Trading Commission and the futures industry are an important part of the oversight of the Committee on Agriculture. In 1974, when the CFTC was created, virtually all trading was agriculturally oriented. Since then, every reauthorization has been considered by our committee. Today, the percentage of business that is agriculture is much smaller, yet the number of agricultural futures traded has grown dramatically.

I am very pleased that the industry has grown and prospered while providing an extremely important risk management tool that the marketplace uses each and every day, and more and more every day. It is my view that the Commodities Futures Modernization Act of the year 2000 may be one of the most successful pieces of legislation that has passed out of our committee, certainly since

I came to Congress. Our subcommittee has held a series of hearings already on the implementation of CFMA in the last Congress. We heard a number of folks on a number of topics, and the discussion about current issues from the regulatory perspective as well as the view of the overall competitiveness of the industry. At that time, during that series of hearings, it appeared that CFMA had accomplished much of its intended purpose, regulatory relief to foster industry growth and a level playing field, while still protecting market integrity and transparency for all participants.

Now, in the over 4 years since the passage of CFMA, the futures markets have really developed. In fact, 1.6 billion contracts were traded last year. With this rapid growth and development, there are likely difficulties and challenges. Today, the subcommittee begins a review of the futures industry, starting with the principal regulatory agency, the Commodities Futures Trading Commission. It is my hope that this hearing will provide us and the committee members with a good understanding of what work needs to be done this year for reauthorization of CFMA.

I now recognize the gentleman from North Carolina, my ranking member and friend, Mr. Etheridge.

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

Mr. ETHERIDGE. Thank you, Mr. Chairman, and I thank you for calling this meeting, and I am particularly pleased that we will be working together on this subcommittee, not only to address the subject of today's hearing, but also, other issues that may be confronting the subcommittee and Congress.

Four years ago, as you have indicated, Congress took a bold step in dramatically amending the Commodity Exchange Act, and changing a system of derivative markets regulations. As you will recall, it wasn't easy. Many of us here remember that. Congress was faced with several different and often conflicting patterns toward changes that were offered by a wide range of industry participants. But boldness was necessary in the face of technological advantages within the industry, and increasing foreign competition in the derivatives business, and in the Commodity Futures Modernization Act of 2000, Congress delivered.

And we have seen the results of Congress' work. From 2000 to 2004, the volume of futures and options contracts traded on the U.S. exchanges have almost tripled. The number of products on these exchanges have more than doubled. And we have seen the entry of several new participants into the U.S. marketplace.

Mr. Chairman, the testimony we will receive today and at subsequent hearings will sing the praises of the CFMA, and it should. Nevertheless, we should not take this success story for granted. While a strong case can certainly be made for leaving well enough alone, and passing a simple 5 year extension of the CFMA, a strong case can be made for addressing the potential problems that remain within the industry, if any, and determining what else can be done to further strengthen the U.S. derivative markets, making it more efficient, making it more liquid, and making it more competitive.

So I commend you, Mr. Chairman, for holding this series of hearings to examine comprehensively the effectiveness of the Commodity Exchange Act. It is my hope that over the course of these hearings, we will thoroughly air some of the concerns that have been raised in the industry with regard to the adequacy of our regulation of energy derivatives, whether or not the regulatory regime related to the trading of single stock futures is hindering the health of that market, and whether or not, in the light of recent court decisions, the CFTC has adequate tools to crack down on fraudulent currency trading options.

So Mr. Chairman, I am grateful for you beginning this process early. I want to add my welcome to the CFTC's Acting Chairlady for this morning. Thank you. And I look forward to working together with all of the members of this subcommittee in the process of the reauthorization of the Commodity Exchange Act. Thank you.

Mr. MORAN. Mr. Etheridge, thank you very much. In the presence of the gentleman from Minnesota, Mr. Peterson, I would like to take the opportunity to welcome you as the new ranking member of our subcommittee, and tell you what a pleasure it will be to have you by my side, with all due deference to Mr. Peterson, really.

Any statements for the record will be accepted at this time.

[The prepared statement of Chairman Goodlatte follows:]

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

Mr. Chairman, I want to commend you for holding this hearing today and getting an early start on the Commodity Futures Trading Commission's reauthorization.

The last reauthorization, which began in May 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 round of reauthorization will be significantly less complicated and less controversial.

To be sure, areas of controversy still exist—in energy derivatives, in sales of off-exchange forex instruments, in single stock futures regulation, and in the continuing globalization of electronic trading. I am hopeful we can sort these matters out through the hearings in this subcommittee and the full committee will hold.

I am also confident in the CFTC's ability to police our derivatives markets. I believe the amendments that were adopted in 2000 for the most part set a course for wise use, by large and small businesses alike, of an array of risk management instruments. While forming the basis of sound business practices in different venues, these instruments remained cost-effective.

Additionally, I am heartened by the steady rise in trading volumes at this Nation's futures exchanges. These increased volumes provide evidence that our exchanges still offer a unique product that may be used efficiently and with reasonable safety. I also assume these rising volume numbers mean that financial service firms, offering tailored over-the-counter products to their customers, are laying some of their risk off on the organized exchanges. I believe that was the hoped-for outcome, and I would like to learn more about whether or not our exchange officials and others believe that this is the case.

Thank you for the opportunity to offer some of my thoughts on this important legislative undertaking.

Mr. MORAN. We are delighted to begin oversight review and reauthorization of this act today, and we are delighted to have a very important witness. Chairman Hruska, thank you for joining us, and our attention now turns to you.

With unanimous consent of the subcommittee, I would request that we allow the witness longer than the 5 minutes. In fact, I have suggested that she can have 10 minutes to tell us her story. And with no objection, we will proceed in that manner.

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

Ms. BROWN-HRUSKA. Thank you, Mr. Chairman. I appreciate very much the opportunity to be here this morning. I would like to also thank Ranking Member Etheridge and all the members of the committee for coming. I am pleased to appear on behalf of the Commodity Futures Trading Commission to discuss the important issues that surround the reauthorization of the Commission. Before I begin my testimony, I would like to recognize and introduce my fellow colleagues on the Commission who join me here today. First is Commissioner Walt Lukken, who is certainly no stranger to many of you because of his experience working on the Hill. I joined the Commission at the same time as Walt, and I have greatly enjoyed working with him over the past two and a half years.

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

Finally, I would like to recognize and commend the staff of the CFTC. There is a big crowd of them behind me here, and I actually, at one point, was on the staff of the Agency in the early '90's, and I really was able to see firsthand the dedication they devote to the Agency and to the industry that they regulate. I want to thank them for their energy and the creativity that they bring to the task. Without this energy and dedication, I am sure much of the innovation that the Commodity Futures Modernization Act of 2000 enabled wouldn't have been possible.

Well, it was just over 4 years ago that Congress passed the CFMA. While this may seem like a short time, the amount of change that has occurred in the futures and derivatives industry over this period has really been extraordinary. Much of that change has been facilitated by the flexibility and innovative foresight of that legislation. I like Congressman Etheridge's comment, when he said boldness was necessary, and Congress showed boldness, it is something to be very proud of, that you had a role to play in energizing this industry. Today, I would like to take the opportunity to brief you on the CFMA, the progress that we have made in its implementation, what has worked well, and what issues Congress may wish to consider during its deliberation on reauthorization this year.

Overall, as you have mentioned before, the act, as amended by the CFMA, has functioned very well. The CFMA has provided flexibility to the derivatives industry, and legal certainty to much of the over-the-counter derivatives market. This flexibility has allowed the industry to innovate with respect to the design of contracts, the formation of new trading platforms, and the clearing of both on-exchange and off-exchange products. There has been a bounty of innovation. The industry is no longer overburdened with prescriptive

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

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

Since the passage of the CFMA, you have mentioned that the futures industry has experienced phenomenal growth and innovation. We have designated new contract markets, we have seen the emergence of exempt commercial markets and boards of trade that have filed notification with the Commission, and we have seen a flourishing of new contracts and new mechanisms to transfer risk.

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

Well, one of the benefits that has come about from this innovation has been increased competition and the lowering of trading costs. In response to the USFE proposal to list contracts, the Chicago Board of Trade dramatically reduced its execution fees on its market. In addition, the Board of Trade reacted to USFE by offering, for the first time, contracts based on German securities that were previously traded exclusively in Europe.

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

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

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

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

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

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

Now, we are aware that last year's energy bill contained several provisions that would have directly affected the CFTC's oversight responsibilities, and we believe that it is appropriate and timely for our authorizing committees in Congress to consider and weigh in on these proposed changes. The proposed changes sought to make it clear that the Commission has the authority to bring anti-fraud actions in off-exchange principal-to-principal transactions, such as those that occurred in the Enron Online type of environment. While the CFMA provided for the Commission's fraud authority

over exempt markets, some have questioned whether its application to bilateral and multilateral transactions would hold up, given that our fundamental fraud authority appears to pertain only to intermediated transactions. It has been the Commission's contention that Congress intended to give the Commission fraud authority under the CFMA. Nonetheless, if that was not Congress' intent, or if they feel that they need to make it clearer, Congress may wish to provide us with additional guidance regarding this area of the act.

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

As you know, the CFMA was noteworthy, in part because of Congress' decision to permit the trading of futures on single securities, under the joint jurisdiction of the CFTC and the Securities and Exchange Commission. However, more than 4 years after the CFMA's passage, the growth of single stock futures continues to be modest at best. In December 2004, the NQLX exchange, one of the two exchanges that had been offering single stock futures, suspended trading.

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

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

The CFMA clarified the CFTC has jurisdictions over retail foreign currency futures and options contracts, whether transacted on-exchange or over-the-counter, as long as they are not otherwise regulated by another agency. However, as demonstrated in the recent adverse *Zelener* decision, a case litigated by the Commission, the CFTC does continue to face challenges in its jurisdiction based on how retail forex transactions are characterized. In this case and others, defendants often argue that transactions allowing retail customers to speculate on price fluctuations in foreign currency are

not futures contracts, but are spot or forward transactions outside our jurisdiction, including outside our fraud authority.

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

As noted, it has only been 4 years since Congress enacted, and the Commission began implementing the CFMA. Given the progress made and the lessons learned, Congress may determine that it is premature to open the act to significant changes. The Commission has been able to effectively work within the current structure of the act to police markets, to ensure the integrity of the price discovery mechanism, and to maintain the financial integrity of markets and to protect customers. Nonetheless, the Commission stands ready to offer its assistance as Congress moves through the reauthorization process and considers a range of potential options.

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

Thank you, Chairman Moran.

[The prepared statement of Ms. Brown-Hruska appears at the conclusion of the hearing.]

Mr. MORAN. Chairman Brown-Hruska, thank you very much, and welcome to the other Commissioners that are present with us today. And I want to focus my initial questions on the forex and the *Zelener* case.

It appears to me that the case has thrown a wrench into the workings of CFTC's enforcement authorities, and it seems to me that the court has redefined what a futures contract is. In the *Zelener* court case, it seems to say that a futures contract is a futures contract only if it is traded on an exchange. I would like your impression of what you believe the court has said, and what do you think that decision does to affect your ability to enforce boiler room operations?

Ms. BROWN-HRUSKA. Well, thank you very much, Chairman Moran, for asking that question. It is of great concern to the CFTC, just looking in that case, we believe that *Zelener* does not limit futures contracts only to those contracts traded on an exchange. But instead, it really shifts the emphasis regarding the evidence that the Commission must offer in forex cases to prove the existence of a futures contract. So at least in our reading of the case, it doesn't say it has to trade on an exchange for us to have jurisdiction. Instead, it focuses on the character of the contracts traded.

Zelener was decided on the facts before the court, and took issue with some of the evidence we presented there, and have presented in the past, to argue that a contract is a futures contract. The court noted, for example, that “treating the absence of ‘delivery’ as a defining characteristic of a futures contract is implausible,” and that “using ‘delivery’ to differentiate between forwards and futures contracts yields indeterminacy.” So ultimately, as I have been advised by the staff, I think the court found that the customer’s ability to exit a transaction by offset might mean that a given contract operates as if fungible, but that the evidence was insufficient in that case to permit the court to determine whether such an obligation existed in the contracts at issue in that particular case.

In short, while the Seventh Circuit has not been a hotbed of forex boiler room activity to date, the Commission fully expects to continue to prosecute any forex boiler rooms in this Circuit, offering evidence that the contracts were, in fact, fungible, were capable of offset, and in fact, operated as if they were.

So we think that we do have significant authority, and that we are—it is not an issue of where the contracts are traded.

Mr. MORAN. Chairman, do you have cases pending in other Circuits under similar circumstances and a factual basis?

Ms. BROWN-HRUSKA. I think yes, we do have some other cases that we have brought, and I think you are right on a factual basis, that is—in some sense, *Zelener* provides us with information as to how we should bring up those facts and circumstances of the case, to better win those cases.

Mr. MORAN. Was the factual circumstances surrounding the *Zelener* case unusual, different, or that is—it is a factual case that is typical of the kind of case you would bring in this setting? The things that are unique about *Zelener* that make a court decide the way it decided, such that we would expect to have this kind of decision elsewhere?

Ms. BROWN-HRUSKA. Well, actually, no. I think that we have—as I mentioned before, most of the cases that we brought which were similar in circumstances, in terms of what—they were boiler rooms, as you mentioned, a bunch of crooks trying to get innocent people to part with their money. I think a lot of those cases we have won, so in some sense, we have seen a lot of cases where there are similar circumstances, and we have been able to prevail.

And so we take it as some comfort that we may have made some mistakes in the *Zelener* matter, that we may have not brought the full force of the evidence we had, particularly with regard to the offset provision, to that court.

Mr. MORAN. But there is now court proceedings pending in other cases similar to *Zelener*, in which the outcome may or may not be the same? Is that true?

Ms. BROWN-HRUSKA. Yes, sir.

Mr. MORAN. Thank you very much. I recognize the gentleman from North Carolina.

Mr. ETHERIDGE. Thank you, Mr. Chairman, and thank you again, Madam Chairwoman, for being here this morning and coming.

In a number of the sections in your testimony, you suggested there are areas where Congress might wish to consider changes in the Commodity Exchange Act. A big factor in considering, in deter-

mining whether or not we make changes will be the—of course, your point of view. The agency experts seem to be the best place to get advice on these areas, so with that in mind, let me refer to the areas that you mentioned in your testimony, and get your opinion.

Should the CEA be amended, as you have talked about? Number one. It says make clarification for the legal framework provided for exempt markets. Number two. Make effectively, avoiding duplicate burdens on the market, and provide guidance and support with respect to CFTC interaction with other agencies. And third, ensure that the CFTC has clear and adequate authority to police retail fraud, particularly in the foreign exchange areas.

If you would share with us on those three areas.

Ms. BROWN-HRUSKA. Well, thank you very much, Congressman. As I mentioned, the CFTC does stand ready to assist Congress as it makes the law that governs the industry. It is true, we are the regulators, and we are just one part of the process. I certainly appreciate that you do look to us for our position, and we will certainly provide that to you, but we believe that this is, in many respects, this is the first opportunity for us to bring these issues to you, and we would suggest that you also need to have the benefit of the industry input. You need to hear from firms. You need to hear from end users, folks who use the market, folks who want to use the market.

We have to understand their issues, the people who are in the markets, who use the markets, who run the markets. Now, we at the Commission, and I think all of the Commissioners will be happy to share our views and our assessment of the need and the effect of any change going forward. I brought the three particular areas to your attention, because they are a source of concern to the CFTC, to all, to myself and the other Commissioners, significantly. We have talked at length about the exempt markets, and it is interesting you raise that issue. We raise that issue, and one reason I put that out there for Congress, it actually turns out that there is a lot of disagreement as to what Congress did intend in many of the aspects of the energy markets and the statutory language involved. So I would say that how we interpreted it was that we had authority in many of those areas, to bring cases where we see wrongdoing, and that is how we see our marching orders. But if Congress did not intend for us to have that authority or if there is some conflict there, we need to hear from you.

I think, again, we want to avoid, in the case of the single security futures, in avoiding duplicative burdens. I think it is a challenge for two regulatory agencies to jointly regulate a product, and we have worked very hard to try to establish good relationships with the SEC, to get some of the job done there.

The last point that you asked was: do we have adequate authority to police retail fraud? Again, it is still an issue that I think the industry is working on, and we also are working with the industry to try to get potential solutions, to ensure that we can bring these cases.

Mr. ETHERIDGE. Let me try to get one more question in my first, and you might want to expand on that in writing a little later, if you will. Let me be a little more specific on the duplicate burden

and guidance portion of your statement. Some have argued that the overlapping jurisdiction of the CFTC and SEC is the source of failure of the security products to really take off. We haven't seen a whole lot of movement.

Your testimony speaks of the successful cooperation with the SEC, which is, I think, fine and good and very appropriate. But I would like to hear any disagreements or disputes that may have cropped up. I think this committee would, between the two agencies, relating to the products, and hear about the areas where your disagreements may have created some problems where we can't get movement, that we need to move, to create the trading.

Ms. BROWN-HRUSKA. From my perspective, there were three issues that I outlined, and that I have had some difficulty with, in understanding, or not understanding, but some difficulty moving the ball forward with the SEC. I think the Commission has—my predecessor as well—encountered some difficulty the area of margining. I think the intent was that the SEC and the CFTC would get together and come forward with a margining system that wouldn't create regulatory arbitrage between, say, the regulated options markets and the new security futures products.

The problem is that with security futures products, they set the levels very high. Also they are inconsistent with the way futures are margined. Futures are usually margined on a risk-based approach, whereas securities margins are a flat, fixed number, that doesn't change with respect to market conditions or interest rates, or important aspects. So I think it is a fundamental, philosophical difference as to how we can reach agreement on margins when the methodologies that we use in securities and futures are somewhat different? We tend to think that ours is more sophisticated and more appropriate, but—and I am sure they think that theirs is more appropriate. So I think that we have tried to reach agreement, we have tried to get them to consider and to move forward on considering a portfolio of assets, and setting margins based on the portfolio of offsetting assets, and we are still intending to try to push them. But margins are important. The reason I have spent some time on it, because that is the cost of trading. I mean, that is the cost of using these products, and if it costs too much to take a position, and to get in and out of it, and to manage your risks that you face, or to diversify your portfolio, you just won't use it. So I think that margins are one of the key issues that we really will work hard to try to get agreement on.

Mr. MORAN. The Chair recognizes the gentleman from Ohio, Mr. Boehner.

Mr. BOEHNER. Thank you, Mr. Chairman, and Madam Chairman, we welcome you to the committee. And as Mr. Moran pointed out in his opening remarks, the CFMA has been wildly successful, and a lot of us have worked on a lot of bills during our tenure in Congress, but when we look at the Commodity Futures—the Modernization Act, I think we did, in fact, get it right, and having been through at least three of these reauthorizations of the Commodity Exchange Act, I remember when we decided that we were going to create all the regulations over what should happen in the exchanges, which may have stopped some potential abuse, but certainly limited the ability of the exchanges to grow and to modern-

ize, and to deal with, certainly, all the new types of contracts that we have, and when we did the CFMA, in allowing a different regulatory scheme to into place, more self-regulation, we did, in fact, open up the exchanges to great modernization, far more new, different, and innovative products, and as we go through with this reauthorization, I am hopeful that the overall model that we created will not change. And frankly, from where I sit, I don't see a great need for it to change, and as we look at the tinkering that you and others may suggest, I think we need to be somewhat cautious about overreaching. Clarifying it would be one thing, but overreaching in terms of how far we go is something that I have some concerns about. The simpler we keep this, the better off I think we will all be in terms of getting the Commodity Exchange Act reauthorized this year.

Single stock futures. Mr. Etheridge was asking a number of questions. You addressed it in your opening remarks, and it has been 4 years. We are still—we are getting off to a very slow start. I understand it is not the easiest thing in the world to work with the SEC or, for that matter, to have two regulatory agencies trying to come to some agreement. Having been involved in the Financial Services Modernization Act, that involved half a dozen regulators and dozens of industries, I thought the industries were a problem, trying to get them to the table to come to some agreement, until I got to the regulators, and if we in this Congress think the turf is important, you have not seen anything until you have seen regulators try to come to some agreement on turf.

The market is out there, and I think that these are important products that could serve to be very significant risk management tools, and at least for one member that is sitting up here, I would hope that we would find some way to work through the turf battles and to come to some agreement on these products, and how we are going to regulate these products, so that we, the government, can get out of the way, and let the markets do what they are supposed to do.

So can you give me some hope?

Ms. BROWN-HRUSKA. I enjoyed your comments immensely, sir. Congressman, I think that you are absolutely right. These products are offer great opportunity to market users. I have a lot of my money in a Government retirement account and a professor's retirement account, and it is just locked in these market indexes, and a couple of years ago, I started to sweat, because I think man, the technology is going down, and I sure would like to get out a little piece of that, or soften that part of my portfolio. If I had had narrow based technology index, as an individual investor, I could go to the futures markets and take a short position, and it is basically a portfolio diversification tool that I think individual investors and commercial market participants who want to hedge deserve to have, at a low cost, and an efficient, liquid market, and I commend the industry, NQLX and One Chicago for bringing forth and making the investment into these products, and I think we, as regulators, really have to commit to you, and I certainly do, that we will do everything we can to come to agreement to lower the costs of trading, and to offer—to ensure that these products do have an opportunity to succeed.

Mr. BOEHNER. Thank you.

Ms. BROWN-HRUSKA. Thank you.

Mr. MORAN. Thank you, Mr. Boehner, for your historic insight. The gentleman from Minnesota, Mr. Peterson, the ranking member of the full committee.

Mr. PETERSON. Thank you, Mr. Chairman, and thank you for holding this hearing, and welcome, Madam Chairman. Apparently, the *Zelener* case that you mentioned in your testimony has important implications for the Commission's jurisdiction and ability to police these foreign currency trading scams, and the CFMA, as I understand it, was intended to clarify the Commission's jurisdiction in this area, and you point out in your testimony the track record of the Commission, where you have filed 70 cases, I guess, and prosecuted 267 companies and individuals, recovered \$240 million in fines, and we commend you for that. Those are all good measures, but what we really want from an enforcement program is a reduction in the amount of fraud that is committed. So in your opinion, based on the Commission's surveillance and enforcement activities, has there been a reduction in fraudulent activities in wake of all these successful enforcement cases, and can you demonstrate that?

Ms. BROWN-HRUSKA. I think yes. I think that what we see is that this kind of fraud, I mean, I won't say that—forex is kind of the fraud du jour. It is the hucksters are out there saying the dollar is low now, you can make money like the big guys, this amazing profit potential, by going into trading forex in some sense, we have seen this before, and in other areas. We see it in heating oil, for example, almost every season, before the winter season. And we have seen it in options, in the early 1970's, before the Commodity Futures Trading Commission was established. We have struggled a lot with fraudsters. They will go from one commodity and one asset to another, to try to get customers to part with their money.

I would qualify my answer, and say that, in fact, it may be the case that we are seeing more forex fraud, it seems like with the advent of the Internet, and there are more sort of avenues for fraud in derivatives and in foreign exchange. It may be that just that by virtue of the fact that the markets have grown, and that the dollar has been weak, that we are seeing more fraud.

Mr. PETERSON. Thank you. Apparently what happens from some of the time these firms that are committing this fraud, using these Ponzi schemes or other methods for misleading investors. From what I understand, they get shut down, and there are settlements with you, and then they pop up in another form, in another place, and run the same scams over again. Is that true, and do you think that happens often? I have been informed that that is going on.

Ms. BROWN-HRUSKA. What we try to do in these cases is work with criminal authorities to put these guys behind bars, and I think we have had some success. In fact, we are just filing a case right now for someone who—put behind bars for a number of years, and as soon as he got out of jail, he immediately started doing it again, and so we are shutting him down again, freezing his assets. And we do try to work with state criminal authorities, and other government agencies, like the Department of Justice, for example, to try to use everything at our disposal to take these guys out of

the market. As you mentioned, they are very resourceful, they are very clever, and they will move from to one commodity to another. They will move from one state to another. They will change their story. They will change their name. It is a real problem.

Mr. PETERSON. Well, and apparently, these activities violate state laws, I guess, and Federal laws other than the Commodity Exchange Act. Is that correct?

Ms. BROWN-HRUSKA. Yes.

Mr. PETERSON. What kind of cooperation do you have working with these other enforcers, and do you think this is a good responsibility or mission for you guys, or would it be better off if the state and other Federal agencies were given this task to do this?

Ms. BROWN-HRUSKA. Well, 3 years ago, we established the Office of Cooperative Enforcement within the Division of Enforcement, and the purpose of that office has been to educate state, local, and fellow Federal authorities on how to prosecute this kind of illegal conduct. As a result, we have been successful in getting these state authorities to not only refer cases to us, but also, having them bring criminal actions against off-exchange boiler rooms, specifically in the area of forex. This is an ongoing process, as we are in the process of organizing a training conference in the near future, in fact, to bring all states together to capitalize on coordination and manpower. And I would even add that I have been talking with my fellow Commissioners about this issue, thinking of ways that we can increase our education of consumers that would fall prey to this activity, and so we are kind of two-pronged. We want to try to educate and work with other law enforcement authorities, and we would also like to get the word out that we are serious about shutting these guys down. Thank you.

Mr. PETERSON. Thank you. Thank you, Mr. Chairman.

Mr. MORAN. Thank you, Mr. Peterson. The gentlewoman from Colorado, Ms. Musgrave.

Ms. MUSGRAVE. I don't have any questions at this time, Mr. Chairman. Thank you.

Mr. MORAN. Thank you very much. The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

You have identified a number of issues that you think Congress might want to weigh in on, but you have expressed no opinion about how Congress might wish to actually weigh in?

Ms. BROWN-HRUSKA. Well, as I said before, and I appreciate your raising this issue, because we are actually very anxious to consult with you, and provide you with what we know.

Mr. MARSHALL. Since we have got such a brief period of time, it would be helpful to me, and I think more helpful to the committee and to Congress generally, if you and the other Commissioners would—particularly, if you have all pretty much agreed with your staff, your lawyers, if you would make recommendations, specific recommendations to us, for how the CFMA ought to be modified in order to address the issues that you have identified. Simply highlighting the issues, and doing no more than that is not nearly as helpful as if you would give us your opinion, your expert opinion, on how these issues should be addressed. Take the *Zelener* decision. I can't imagine that you were happy with that decision.

Ms. BROWN-HRUSKA. Oh, no, we are not.

Mr. MARSHALL. I would imagine that those lawyers on your staff who were prosecuting that case were pretty chagrined and surprised. They thought they had done their job, and you probably haven't told them that they weren't doing their job, that they had done it inappropriately. It may be a decision that you can live with, and that you can work with in the future, in the sense that you are going to have to change the way that you prosecute your cases, but another way to address it is to suggest to us how we might modify the CFMA so that you don't have a *Zelener* type problem in the future with addressing these kinds of fraud cases. And so I guess what I would like to ask you to do, and if you could just say yes, I will do it, or we will do it, that would be great. Is would you, with regard to each one of these issues, make specific suggestions concerning what Congress might do to address the issue? You all have in mind what you would like. You just haven't suggested what it is, and so if you could just give us the statutory language, and the reasons why that statutory language would be appropriate to adopt, it would be real helpful to me, and I think, to the balance of us. How you would like to address the *Zelener* problem. You would like to clarify your authority here, and that language that you could use to do that. If you would just give us that language and tell us what effect that language would have, and why you need it, that would be helpful. The same with the other issues that you are having. Are you willing to do that?

Ms. BROWN-HRUSKA. Oh, yes, sir. Absolutely.

Mr. MARSHALL. That would be great. Maybe the chairman can suggest a date by which that might be done.

Ms. BROWN-HRUSKA. As I mentioned before, I really—

Mr. MARSHALL. We are going to hear from industry. You have already said that. We are going to hear from all kinds of other folks. We need to hear from you as well. So we have started with you. If you could give us your opinion, we view you as being unbiased here. You don't have an ax to grind. You just want to do a decent job of enforcing and advancing these markets. And so if you could do more than just identify the issues, if you could provide us with your suggested solutions.

Ms. BROWN-HRUSKA. Well, thank you very much, sir.

Mr. MARSHALL. I will make one more observation. I have spent years before being a mayor and being in Congress, as a lawyer and a law professor, and the 70 and 3 record cuts two different ways. I mean it sounds great, like you all do a wonderful job in prosecuting your cases. But a lot of lawyers would say that just means you are not prosecuting enough cases. You should have more that you lose. Now, I don't know whether that is the case or not. I don't know enough about what you do, obviously, but this boiler room problem is catching an awful lot of people. And I am sure you are going after it as aggressively as you can, but just going—you just prosecuting the winners exclusively means that there are a lot of winners out there that you just didn't put enough effort into. That is what a lot of lawyers would say. I appreciate hearing from you, receiving from you your specific suggestions, the statutory language, and the arguments that support adoption of that language for each one of these issues.

Thank you.

Mr. MORAN. I thank the gentleman from Georgia. The gentleman from Louisiana, Dr. Boustany.

Mr. BOUSTANY. Thank you, Mr. Chairman. I have one question, and it really pertains to the energy markets, and some of the provisions you mentioned here in your testimony refer to, and you also refer to last year's energy bill. I want to know if everything you are asking for, in terms of specifics, were in that energy bill, or is there additional clarification of specific recommendations you are making with regard to energy markets?

Ms. BROWN-HRUSKA. Yes we did, in fact, consult with the authorizing committees, for example, last year, when that energy bill was being considered. I think there were some very overreaching and significant changes to our authority that had been suggested. I would say that we felt, and given our experience, that these changes were sensible—and I can certainly outline them for Congress, we thought they were sensible, and would not send the industry into a tailspin, but it would increase the clarity with respect to our jurisdiction. So we would be glad to discuss those further. They are very limited. There were just, I think, four or five changes that we thought would be worth considering.

Mr. BOUSTANY. And those were not considered overly prescriptive? You were satisfied, in other words, that it would meet your needs?

Ms. BROWN-HRUSKA. Yes. Yes, sir.

Mr. BOUSTANY. Thank you. That is all I have, Mr. Chairman. Thank you.

Mr. MORAN. Thank you very much, Mr. Boustany. The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Chairman, it has been a little over 4 years since the last reauthorization Act was enacted, and a key modification of that law was that the CFTC's role of prescribing rules for exchanges, the follow was removed. And the exchanges were given the responsibility to comply with core principles. While it is true that trading volumes have increased dramatically, they also increased large amounts in periods before the CFMA was enacted. What tells you that anything has really changes as a result of the change in the statute?

Ms. BROWN-HRUSKA. I looked at a chart just yesterday. I asked for a sort of an update on progress that our markets have made, number of new contracts offered, and volume, and it is significantly increased since the year 2000, or since the CFMA was passed, which as an empirical matter, making that relationship, say, because of CFMA, if this, then volumes and contract innovation increase, it is a bit of a leap. But I believe just by observation, anecdotal as well, part of it is the speed with which we are able to approve, it is the flexibility that the industry has to think of new ways to meet their customers' needs and their demands, that the CFMA really enabled, because it sort of takes the day to day, approval process away from the CFTC, and allows exchanges, when they are not materially different changes, but significant concerns from a regulatory perspective, but are innovative—it allows the exchanges to certify those changes, allows markets to set up different

market structures, that maybe weren't contemplated when the exchanges developed. So we are actually seeing new, different types of markets that offer different levels of—different ways of coalescing buys and sells, and different ways of satisfying customer demands. So we are literally seeing quite a flourishing of the markets.

Mr. SCOTT. We recently gave the CFTC pay parity authority, that is, the right to set personnel pay levels outside the general schedule for Federal employees. How has this authority been used, and what effect has it had?

Ms. BROWN-HRUSKA. Well, thank you very much for asking that, Congressman. It is one of those issues that has been very important to the CFTC. Prior to pay parity, and Congress did give us that authority to offer pay parity, we had a terrible attrition rate. We lost so many talented, smart people. You have got to realize, futures and derivatives are—they are complicated transactions, and you bring somebody along, and you develop their knowledge and their skills, and then they run off to the private sector, or even worse, they run off to another financial regulator, and so we really needed to stop the flow of this high quality talent from the CFTC. Part of the problem was that others were able to pay a lot more. And so pay parity enabled us to at least bring our pay up to the level that we were seeing in other financial regulatory agencies. We evaluated how their pay systems worked, and we came forth with a plan. In fact, we are still in the process of implementing certain aspects of it, more performance based pay and the like. But it has stopped the attrition. We are now down to, I think, a normal level for a government agency, or a federal financial agency. We are consistent with those, and we have been able to build up a strong base of staff, it has been a challenging experience from a resource management perspective, because pay parity, in essence, means that we have to pay our people more to bring them up to the levels that we saw in financial regulators, so we have to sometimes make sure that we have to use every resource that we have at our disposal, so that we are able to do that. But it has been a very big success for the CFTC in improving our performance.

Mr. SCOTT. So you do feel that you have the adequate resources to accomplish your mission.

Ms. BROWN-HRUSKA. Yes, we do. Thank you, sir.

Mr. SCOTT. OK. Thank you. Thank you, Mr. Chairman.

Mr. MORAN. Thank you, Mr. Scott. The gentleman from Texas.

Mr. NEUGEBAUER. Mr. Chairman, thank you. Chairman Hruska, thank you for being here. Some have called for some price position limits in—when it comes to trading some of the energy markets. Others say that it is just a volatile market. It should be left to trade on a fairly free basis. What is your position on that?

Ms. BROWN-HRUSKA. We have always had, from the exchanges' perspective, we have always had, exchanges have had the ability to set price and position limits, to curtail congestion, prior to the delivery, or to ensure that there weren't traders who were taking unusually large positions, and moving the market unduly. And so it has been one of those things where exchanges have had, in most instances, a good bit of authority to put in these limits, and we have seen, historically, we have worked very much with the ex-

changes in their setting of those limits, and in their monitoring, and they change them from time to time, to, for example, deal with changing market conditions. I know we have seen a lot of growth, for example, in the ag markets. A lot of grains still have federally mandated speculative position limits. Because of all the growth in the markets, and the new participants, and we have seen that they have a desire, for example, to raise limits in those markets. So and then, we hear in the natural gas markets that there are some people who think that those limits should be lowered. But what we have done is we have relied on the exchanges to determine the limits based on their customers, that participate in those markets, and their monitoring of the day to day changes in prices, and we have had generally a very good, I think, experience. If we have a concern about, for example, their levels that they have set, we will let them know, but generally, I think that the exchanges have done a very good job of administering those limits. So I guess my answer is that we are satisfied and very comfortable with the current mechanism for setting limits.

Mr. NEUGEBAUER. So you think the exchanges are managing that process effectively and efficiently?

Ms. BROWN-HRUSKA. I think that they are, yes.

Mr. NEUGEBAUER. Based on the *Zelener* case, it looks like somewhat of that case is over definition of what is a futures contract. As we go back and maybe look at some tiny fixes or something like that, is—would some language clarification in some of those areas be helpful or not?

Ms. BROWN-HRUSKA. Well, I think one thing that we worry a little bit about when it comes to coming up with a definition and putting it in the statute is that we will give criminals a roadmap to what they can do, so they can avoid our authority. So there is—in some sense some advantage to allowing us, through our court cases and through our actions, to provide signals, and to provide guidance as to what we regard as illegal conduct and illegal activity. So we have had discretion. In the past, we have tried to utilize that discretion appropriately by going after egregious fraud, all fraud, in this area. We have tried not to expand our authority such that we find ourselves regulating the currency inter-bank market, populated by major banking institutions. We don't have that authority. We don't have that desire to get involved in that space. The banking agencies take care of it. So that is one of our concerns, that sweeping legislative changes or statutory language that might bring forth some definition or some overspecificity may actually create a difficulty for us.

Mr. NEUGEBAUER. And last question. This has been in effect for 4 years, and it is an impressive amount of activity that has increased in the markets and the new products, and of course, one of the things I believe very strongly is that government not get into the knee-jerk reaction of changing policy on a very frequent basis, because what makes markets more efficient is once they understand what the rules are, they begin to operate effectively, and I know we are going to hear from the industry themselves, but all in all, do you feel like that the current structure that you are working under is working, and that we shouldn't make any material changes to it?

Ms. BROWN-HRUSKA. Yes. I think that the structure is working remarkably well. Again, I kind of want to tell you why I qualify, in my remarks, why we are not bringing forth specific changes. First, because there is this concern that by doing statutory changes, you will have these unintended consequences that could quell some of this growth and vibrance that we are seeing in the legitimate marketplace. So we are very cognizant of sort of the costs and benefits of changing the act, and so I would say that we are very comfortable with the act as it is now. We have found that we have authority to bring a significant amount of cases in the energy and the forex area, and some of these issues really, in terms of, like, the forex area, some of them are fine legal questions that we could maybe do a better job of proving up our cases, or maybe we could be more specific nailing those aspects that the court seems to think we need to nail to bring—to succeed in those cases. And we can do that without changing anything in the statute. So thank you for raising that.

Mr. NEUGEBAUER. I think my time has expired, Mr. Chairman. Thank you.

Mr. MORAN. Thank you, Mr. Neugebauer. The gentleman from Washington, Mr. Larsen.

Mr. LARSEN. Thank you, Mr. Chairman, for a chance to ask some questions. Quickly, on page 3 of your testimony, you outlined you have taken prosecution of 46 entities to the tune of about \$300 million in the energy market. Could you provide a list to the committee, which those entities are, and how much in each case?

Ms. BROWN-HRUSKA. Yes. It would be our pleasure. Thank you, sir.

Mr. LARSEN. That would be great. Then, on page 4, you talked about the, again, back to the energy markets. In your testimony, proposed changes sought to make clear the Commission has the authority to bring any fraud actions in off-exchange principal-to-principal transactions. That was in the energy bill. It seems to me from that paragraph in your testimony that you certainly believe, that is, the Commission certainly believes it has the fraud authority that it needs, but perhaps that consensus doesn't exist in the energy industry. And so my concern is we will maybe create a situation where you use that authority, but if Congress does not clarify that authority, that maybe there is some legal uncertainty in having that authority stand up. Is that your concern, or is there another, pardon me, another concern that you have about why we should strengthen it? Because if it needs to be strengthened, we ought to be foursquare behind it to do that.

Ms. BROWN-HRUSKA. Thank you, sir. I agree that there is disagreement, and there has been, this issue that has been debated before I even came to the Commission of whether or not certain parts of the act negate or conflict with other parts of the act. Our approach has been to assume that the authority that is clearly given in, say, for example, 2(h), which gives us fraud authority in exempt markets, which are energy markets, our approach has said you know, it says we have authority, we are going to exercise that authority. Surely, clever attorneys for those companies that we go after, or those individuals will argue that no, no, no, you don't have authority. But one thing that we have seen is that we have been

very successful in convincing those companies that they need to come to the table, and that they need to cooperate with our investigations. A lot of them are still seeking to do business, and so it has been a situation where we have—the kinds of activities that we saw in energy, for example, we saw false price reporting. It was a significant problem in that industry, and although, I think that it is one of those problems that is part of the past, because we have brought so many actions under that authority, which makes false price reporting illegal under our Act. So we have been creative in our use of the statute, to make sure that when we find wrongdoing, we can bring—we can take an action, and so in general, I would say that those changes that are—that we are suggesting Congress might want to consider, are kind of, we are clear on what we think Congress intended. Sometimes, it is more of a matter of Congress saying OK, take that ball and run with it. And we would be delighted with that, and that may not result in any technical or marginal changes in the act. We are taking the ball if you tell us to.

Mr. LARSEN. Good. Well, we will—if you need another to ball to take, I think Congress ought to do it, in the energy markets, certainly, we have had, obviously, our own experiences in Washington State and the west coast, so I want to be clear about that. The third thing I want to ask is about 2(g), Section 2(g), and there has been some discussion, recommendations perhaps about repealing 2(g). Could you educate us on 2(g), and then some have suggested that it serves as a loophole that trading entities can use to evade CEA protections, that were otherwise preserved. Can you comment both on 2(g), and then on does it act as a loophole, then, as well, that we need to fix?

Ms. BROWN-HRUSKA. Yes, I am glad you asked that, because it kind of is a good follow-on to your first question.

Mr. LARSEN. Sure.

Ms. BROWN-HRUSKA. Because that is kind of what was in the back of my mind when I was answering. Two(g) is the swaps exclusion. It says that, and I think it was primarily to provide legal certainty for the over-the-counter swaps markets, that had suffered under many years of legal uncertainty regarding whether or not the CFTC would bring a case. There are some who felt early in the development of the swaps markets that they were futures, and I know, as a professor of derivatives markets and risk management that they are different than futures. They have a lot of aspects that are more customized. They are more—the cash flows are tailored to individual consumers, or commercial participants' needs, and so swaps were provided an exclusion for one reason, from the CFTC's authority, because they were different transactions, and they were more customized. And the other reason is that they were utilized and offered, in most instances, by banking institutions, which are regulated by the banking authorities. So the purpose of 2(g) was to provide an exclusion from the CFTC's jurisdiction, but not to let these things out there in the wind, and have no supervision. They are, certainly, I have friends who work for various banking agencies who go out and look at the portfolio of these entities that offer swaps and ensure that their internal controls, and their representations, and their risk management practices are in order.

So in some sense, I think 2(g) is, was an important accomplishment of Congress. It did provide legal certainty, and it would be very dangerous, I think, to send a signal that you would want to repeal that, or you would want to—because that business is—it serves an important risk management function to commercial market users, and those that do global business, and those that do business in a variety of commodities, you depend on hedging their use of, for example, those indexes, and those financial products. So we see a development of those that has occurred. It is a healthy development, a healthy market, and so even though I don't think that we have any demonstrated need to change that exclusion.

Mr. LARSEN. Just quickly—so you don't see it as a loophole, because these swaps are regulated in another field, in banking, so CFTC doesn't necessarily need to have that authority, essentially what you are saying?

Ms. BROWN-HRUSKA. Yes. And it is also the case that they are commercial market users. They are sophisticated users that use these, and often on a principal-to-principal basis, or they are intermediated by swaps, intermediaries that, again, are banking institutions or otherwise regulated financial institutions.

Mr. LARSEN. Thank you. Thank you, Mr. Chairman.

Mr. MORAN. The gentleman from Missouri.

Mr. GRAVES. Thank you, Mr. Chairman. I wanted to follow up on a couple of questions. When it came to trading limits, particularly for commodities like natural gas, and you have kind of touched on that a little bit, and I know you are aggressively, and from your testimony, you have said you are aggressively pursuing any problems that have come up in, particularly in energy trading, but without trading limits for commodities like natural gas, I know you can go after those folks for market manipulation after you see it, but don't you think that having trading limits would at least prevent some of that ahead of the game?

Ms. BROWN-HRUSKA. Well, what type of trading limits are you talking about? Price limits, a lot of times, just stop trading.

Mr. GRAVES. It breaks it up, though.

Mr. GRAVES. It does break it up, though, or at least, attempts to break it up.

Ms. BROWN-HRUSKA. Well, it stops trading in the regulated market, right. That is where a lot of people are advocating for us to enact more draconian limits. It doesn't necessarily stop trading in the underlying cash markets, or in the, say, the voice-brokered markets, or in some other market spaces, so what you might do is if you have too tightly drawn limits, that you will constrain the regulated market from sort of zeroing in on its fundamental value, based on supply and demand. You will constrain that market, and meanwhile, the underlying markets that are still free to operate, in fact, it might cause volume to go to those unregulated markets, because at least, you can accomplish trade when they are not shut down waiting for a limit to be lifted, or for the time to expire. It creates, actually, a fundamental inefficiency in the market if those limits are too tightly drawn. What exchanges have seen fit to do is to monitor the markets, to determine what the average size are of transactions, and sort of optimal levels for limits, and as I mentioned before, our experience has been that the exchanges have

done a very good job of determining limits, and using limits in an appropriate manner, to sort of still have levers of control, when markets get highly jumpy and rather volatile, but not over controlling such that markets are disconnected from their underlying supply and demand fundamentals.

Mr. MORAN. Mr. Graves. The gentleman from North Dakota.

Mr. POMEROY. Thank you, Mr. Chairman. I want to say how much I have enjoyed this hearing, and the chairperson's testimony. You follow much the spirit of your predecessor, Mr. Newsome, who we enjoyed working with in the Agriculture Committee, felt like he, kind of a breath of fresh air, in terms of commonsense regulation out of CFTC. I want to commend your new commissioner, Mike Dunn. I have known Mike for better than a dozen years, to get a good hand there.

Ms. BROWN-HRUSKA. I agree. Thank you, sir.

Mr. POMEROY. A couple of questions that I have. Did you find in the energy prosecution, I see that you have got \$35 million in civil penalties against Enron specifically?

Ms. BROWN-HRUSKA. Yes.

Mr. POMEROY. Did you find that their conduct was particularly egregious in its violation of your jurisdiction, or in violation of the laws within your jurisdiction?

Ms. BROWN-HRUSKA. I think every regulator that has looked at Enron found their conduct to be particularly egregious. I mean, it was indicative, I think, of the time in some respects, because a number of companies were, in some sense, sometimes cooking their books, or were sometimes engaging in very aggressive trading strategies, to try to take advantage of poorly designed markets, and they seemed to lead the way in that aggressiveness.

Mr. POMEROY. They, on the one hand, were highly innovative, in terms of futures trading in the energy sector, but then, they went to the dark side in a very big way.

Ms. BROWN-HRUSKA. Yes.

Mr. POMEROY. While \$35 million sounds like a lot of money, the economic consequences of their market manipulation was far beyond that. Correct?

Ms. BROWN-HRUSKA. Well, I would say our action was specifically for their activities in Enron online, they had a separate platform that we brought an action against them. What we call a 2(h)(1) market, a one-to-many platform and they had violated some of our rules that we have in that market space. And so our specific action was for a small piece of their activity. And I would note that we are still investigating them for some other areas of activity that we want to ensure that—so even though \$35 million, you are right, in the grand scheme of things, it sounds like a good number, but it is really for their particular illegal activity in Enron Online.

Mr. POMEROY. As a regulator, you have got a bankrupt corporation on your hands, further fines may penalize only the other debtors that are going to be getting stiffed by them. So it is a tough line to walk. I note that you also have the jurisdiction, some actions pending against them on individual liability. To what extent are you pursuing individual liability from Ken Lay and company?

Ms. BROWN-HRUSKA. Is it the Enron Task Force? OK. That is good. I had to check with my Division of Enforcement director. He

said that actually, because we still have some ongoing investigations with criminal authorities, the Department of Justice and others, that we can't describe or discuss them specifically at this time, but I think that we may be able to come and provide a private briefing of some of the things that we have and we are working on.

Mr. POMEROY. We will want to pursue that. And I will have an exchange with the chair in just a moment, relative to what this subcommittee ought to do relative to the energy bill, and your role in it. But I do think that is important that this committee exercise oversight authority, and fully understand the dimensions to which you continue to prosecute these violations. I would say that I think there is strong congressional intent, probably right across the political aisle here, for vigorous, personal enforcement of individual liabilities that, relative to key operatives in this corporate structure that engaged in and were responsible for the wrongdoing. I don't think there is anything we can do to really establish bright lines about the energy sector conduct in these instruments, and this type of trading, than to really put some teeth into this enforcement in the most significant individual ways.

I know my time is now up, but Mr. Chairman, I would ask you, we have had a long dance with the Commerce Committee relative to this jurisdiction, and they have been rather openly covetous of our jurisdiction over CFTC over all these years. I think it is terribly important that we stake out our claim to jurisdiction over any portion of the energy bill that would relate to CFTC's ability to bring these types of actions, and I would ask whether you believe the Ag Committee will assert itself as an energy bill comes forward.

Mr. MORAN. Well, the gentleman from North Dakota raises a good point. I would obviously need to defer to the gentleman from Virginia, the chairman of the full committee, but it would be my thought that should CFTC issues be contained in any energy bill, and it is my understanding to date the House version of that energy bill does not include those provisions. The Senate attempted bill has, does, may, and should we get to conference, I would think it would be appropriate for the committee to be engaged in all CFTC jurisdictional issues in an energy bill. But it is obviously an issue that we need to raise with Mr. Goodlatte.

Mr. POMEROY. And certainly understanding that, Mr. Chairman, I would hope that if it is something that is likely to be encountered in conference, that this subcommittee would have ongoing hearings specifically tailored to the energy sector, so that we might appropriately advise our committee conferees, at the time they go in, with appropriate background, that we could develop at the subcommittee level.

Mr. MORAN. And it is a good suggestion. Again, one that we ought to raise with the chairman of the full committee, and see how he wishes to proceed, along with the consulting with the ranking member, Mr. Peterson.

Mr. POMEROY. Thank you, Mr. Chairman. In conclusion, I would just say that I very much enjoyed working on the Commodity Futures Modernization Act, and think of our former chairman, Tom Ewing, and his role in getting this thing passed. I don't know with-

out his persistence, whether we would have actually concluded that landmark legislation.

But we certainly did intend for what I believe, the congressional intent behind that was to essentially let competition work its will, where there weren't regulatory issues, but to leave with CFTC clear authority to police abuses and fraudulent or illegal conduct, and to the extent that your subsequent litigation under the CFMA raises any questions of your legal grounding to bring the kind of prosecutions that we expect you to bring, we will certainly want to tighten that language up in this reauthorization, and so as Mr. Marshall asked, if we could have your very specific recommendations, as you have learned from legal arguments raised under the initial version of the act, we would very much like to know that, so we could include it in the reauthorization.

Ms. BROWN-HRUSKA. Well, thank you, Congressman. I appreciate you.

Mr. POMEROY. Thank you, Madam Chair. Mr. Chair.

Mr. MORAN. Thank you, Mr. Pomeroy. I don't intend to have another round of questions, other than the gentleman from Washington has indicated he has one additional question, and I recognize the gentleman from Washington.

Mr. LARSEN. Thank you, Mr. Chairman. Back to 2(g), Section 2(g). You mentioned the financial services sectors where some of these others, where the swaps are being regulated. Within the energy market, though, are there transactions that are not being regulated that ought to be regulated, with regards to 2(g), or is everything getting done that needs to be done? You focused, you took your answer, and moved it over to the financial services, which I appreciate, but coming back to the energy market generally, how is 2(g) applied, and are some things not being regulated, or are we taking care of everything? Is everything getting taken care of?

Ms. BROWN-HRUSKA. Well, I don't want to oversimplify things. I think that 2(h) is not 2(g), while it is specific to swaps. Whereas 2(h) is specific to energy markets.

Mr. LARSEN. OK.

Ms. BROWN-HRUSKA. And 2(h) is really provided, I think, it was one, again, of the strong points of the CFMA, that it actually provided a means for new markets, electronic markets, like the Intercontinental Exchange, for example, out of Atlanta, to come into being, and other markets, like NYMEX, are providing clearing for over-the-counter markets, products. There are certain things that CFMA enabled, but it is still within a regulatory framework. So in my view, the 2(h) provides us with, still, significant fraud and manipulation authority, and we have an intent to act upon that authority, so again, I don't want to oversimplify and say everything is covered, but virtually everything we have seen, we have been, again, we have been creative. We have brought actions. We have also seen that, for example, where markets developed, areas where we had a concern about, and we raised it with them, they changed their rules to ensure that, for example, that type of activity wasn't occurring any more, and I think it has been a positive experience for us, working with some of these fledgling markets that are trying to get started, and for them as well. So to a short answer long.

Mr. LARSEN. You would be a great Member of Congress. Thank you, Mr. Chairman.

Mr. MORAN. Thank you, Mr. Larsen. Chairman, thank you very much for your testimony and your response to our questions today. I have a series of questions that I would like to submit to you in writing, and would request your reply, in writing, and we want to follow up with you to—in regard to the gentleman from Georgia’s question about specifics, and try to work out a time frame in which you can get that back to us. In addition to that, I hope that you and others can see a strong interest in this subcommittee’s, the membership of this subcommittee in this topic. I was pleased with the discussion and the questions, and the high level of interest that members of this subcommittee have. I think we take our task very seriously, that this is not just about simply concluding that everything is working fine and move forward. We want to make certain that is the case, and make intelligent decisions that not only are useful in the economic sense to the markets and to their customers, and I suppose the overriding of most members of this panel is to make certain that the industry succeeds, but at the same time, its customers are protected, the CFTC has the authority and ability to do its job.

And we look forward to working with you and others to see that that is accomplished. We will have a hearing, again, next Wednesday, in which the exchanges and the industry will be presenting their testimony. I think some time shortly thereafter it would be useful for us to have any specifics of suggested changes that you have in legislative language, statutory language.

Anything else? Therefore, having said everything that at least at the moment needs to be said, without objection, the record of today’s hearing will remain open for 10 days to receive additional material and supplementary written responses from witnesses posed by any member of this panel. And the hearing of this Subcommittee on General Farm Commodities and Risk Management is now adjourned. Thank you.

[Whereupon, at 11:33 a.m., the subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

STATEMENT OF SHARON BROWN-HRUSKA

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

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

Finally, I would like to recognize and commend the staff of the CFTC. Having been on the staff of the agency during the early 1990’s I was able to see firsthand

the dedication they devote to the agency and industry they regulate. As the acting chairman I continue to see not only this dedication, but the enormous energy and creativity that they bring to their task. Without this energy and dedication, I am sure that much of the innovation that the Commodity Futures Modernization Act of 2000 (CFMA) enabled would not have been possible.

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

Overall, the act, as amended by the CFMA, functions exceptionally well. The CFMA has provided flexibility to the derivatives industry and legal certainty to much of the over-the-counter derivatives market. This flexibility has allowed the industry to innovate with respect to the design of contracts, the formation of trading platforms and the clearing of both on-exchange and off-exchange products. The industry is no longer overburdened with prescriptive legal requirements and is able to operate using its best business judgment, rather than that of its regulator. At the same time, economic and financial integrity have been safeguarded and the Commission has been able to maintain its ability to take action against fraud and abuse in the markets it oversees.

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

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

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

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

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

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

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

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

ENERGY MARKETS

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

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

We are aware that last year's energy bill contained several provisions that would have directly affected the CFTC's oversight responsibilities, and we believe that it is appropriate and timely for our authorizing committees in Congress to consider and weigh in on these proposed changes. The proposed changes sought to make it clear that the Commission has the authority to bring anti-fraud actions in off-exchange principal-to-principal transactions, such as those that occurred in the Enron Online-type of environment. While the CFMA provided for the Commission's fraud authority over exempt markets, some have questioned whether its application to bilateral and multilateral transactions would hold up given that our fundamental fraud authority appears to pertain only to intermediated transactions. It has been the Commission's contention that Congress intended to give the Commission fraud authority under the CFMA. Nonetheless, Congress may wish to provide us with additional guidance regarding this area of the act.

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

SECURITIES FUTURES PRODUCTS

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

It is of some concern that this sector has not been more successful and that despite the best efforts of the Commission, the CFTC and SEC have not fully achieved

the goals of the CFMA. In particular, it is of concern that more progress has not been made with respect to implementing portfolio margining; that we have not avoided the double audit and review of notice registered exchanges and brokers; and that we have not determined the appropriate treatment of foreign security indices and foreign security futures products.

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

RETAIL FOREX FRAUD

The CFMA clarified that the CFTC has jurisdiction over retail foreign currency futures and option contracts, whether transacted on exchanges or over-the-counter as long as they are not otherwise regulated by another agency. However, as demonstrated in the recent adverse *Zelener* decision, a case litigated by the Commission, the CFTC continues to face challenges to its jurisdiction based on how retail forex transactions are characterized. In this case and others, defendants often argue that transactions allowing retail customers to speculate on price fluctuations in foreign currency are not futures contracts, but spot or forward transactions outside the Commission's jurisdiction, including its fraud authority.

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

As noted, it has only been just over 4 years since Congress enacted, and the Commission began implementing, the CFMA. Given the progress made and the lessons learned, Congress may determine that it is premature to open the act to significant changes. The Commission has been able to effectively work within the current structure of the act to police markets, to ensure the integrity of the price discovery mechanism, to maintain the financial integrity of the markets and to protect customers. Nonetheless, the Commission stands ready to offer its assistance as Congress moves through the reauthorization process and considers a range of potential options.

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

ANSWERS TO SUBMITTED QUESTIONS

During the 1980's, the Commission, State attorneys general and State security administrators were constantly at odds about how to police off-exchange boiler rooms, especially when attorneys would argue in State court that the Commodity Exchange Act preempted State laws. The CFTC, acting with State authorities, clarified the law and helped prosecute boiler room activity. Are State attorneys general now policing boiler room fraud using State anti-fraud laws?

In recent years, several States have independently or in conjunction with the Commission brought claims under State law and/or the Commodity Exchange Act against commodity boiler rooms and other perpetrators of commodities fraud. Through our cooperative enforcement efforts, the Commission works hard to educate State regulators and prosecutors about the applicability of State law and the CEA to commodities fraud that is committed in their jurisdictions, and frequently has provided assistance to States pursuing these cases.

However, despite the substantial efforts of the CFTC's Division of Enforcement to educate States about the application of State and Federal law, the vast majority of such cases are still brought by the CFTC. The handful of actions brought by States against commodities boiler rooms have been either cease and desist proceedings

under State law, or joint Federal civil actions with the CFTC under section 6d of the CEA. The cease and desist proceedings typically allege violations of State securities laws, and result in orders against the boiler room promoters (often by default) that the respondents evade by avoiding future solicitations in that particular State. In a civil action, a State can join the CFTC in alleging violations of the CEA and can also assert pendent claims under State law. In recent years, the CFTC has participated in one such joint action specifically against a forex boiler room. However, in any such actions in the future, a State alleging CEA violations will face the same jurisdictional hurdles that have blocked the CFTC's efforts in recent forex actions.

The best way a State can attack commodity boiler rooms is through use of its criminal powers; however, State prosecutors face a number of practical and policy-related hurdles in pursuing criminal prosecutions. For one thing, State authorities typically have a broad mandate, and consumer protection is only one aspect of their focus. In addition, State authorities, like other enforcement entities, balance their resources against program goals, and in deciding whether to launch a criminal prosecution will consider the amount of losses by local customers, and the presence of the potential defendants within the State for prosecution. Boiler room promoters often structure their businesses precisely to avoid local prosecution; in its investigations of such boiler rooms, the CFTC has found boiler rooms that deliberately choose to solicit customers outside of the State where the defendants are located. Boiler rooms typically solicit customers nationwide from several locations, through mass telemarketing or the Internet, and an agency that lacks the CFTC's nationwide jurisdiction will often be limited in its ability to investigate this fraud. Finally, State authorities are stretched for resources and often lack the expertise to pursue commodities fraud. The CFTC is finding that States, and sometimes other Federal authorities, will only consider pursuing a matter referred by the CFTC involving commodities fraud if the agency lends to the State the staff and/or technical expertise to assist in their prosecution of cases.

Do you think the 7th circuit created a split amongst the circuits by ruling the contracts in the *Zelener* case were forward contracts not futures?

The Seventh Circuit arguably departed from the precedent of other circuits, and its own precedent, by rejecting the multi-factor inquiry that had traditionally been used to distinguish between futures and forwards, and focusing instead on contractual fungibility and the availability of offset. But that departure relates more to the methodology for determining whether a contract is a futures contract, than to whether the contracts at issue are, indeed, futures.

While we disagree with the outcome, and believe that most other courts would have ruled in a different way, there is no other court decision where the factual circumstances fit four square with the situation that the court faced in *Zelener*, such that a circuit split could be said to exist. Most cases applying the multi-factor test involve the interpretation of the forward exclusion rather than whether the contracts at issue are spot transactions, and even those cases resulting in a different outcome involve contracts that, unlike *Zelener*, are not, in form, spot contracts, and where the right to offset was found to exist.

Finally, however simplified the approach of the Seventh Circuit in *Zelener* may be compared to the traditional multi-factor approach, the right to offset is nevertheless a necessary element of a futures contract under either approach. That common element, therefore, provides the basis for our view that we can prevail in these types of cases under either approach as long as we can establish that element through extrinsic evidence. See *CFTC v. Co Petro Mktg Group, Inc.*, 680 F.2d 573, 580 (9th Cir. 1982) (contract that does not contain wholly standardized terms can still be considered a futures contract if the seller "implicitly guarantees" that it will provide for offset).

What kind of enforcement problems does the *Zelener* decision pose for the CFTC when going after deceitfully marketed contracts?

The *Zelener* decision reaffirms the concept that the right to offset an existing position is a distinguishing characteristic between futures contracts and spot contracts. However, language in that decision could be interpreted to mean that only the written terms of contractual agreements control a court's analysis of whether transactions are futures. We believe the correct approach is for a court to consider not only the written terms of agreements signed by customers, but also whether there are any statements or implicit representations that modify the written terms of an agreement. Such an approach would be consistent with both existing precedent from the 7th Circuit, as well as existing precedent from other circuits. Congress should, therefore, consider clarifying the CFTC's jurisdiction with respect to these types of contracts.

Do you believe there can be a bright line statutorily drawn to distinguish between a forward contract and a futures contract and if so, do you think we should draw it?

It may be premature to draw such a line at this time. The distinction between forward and futures contracts has evolved as the Commission and the courts have addressed the issue over the last three decades. In the law, a futures contract is a legal term of art that obtains its current meaning through a series of administrative interpretations and judicial decisions. Although the CEA does not define "contract for future delivery," it nevertheless provides a statutory foundation upon which the Commission and the judiciary have developed a Federal common law on that subject.

Although Congress could attempt to shorten this evolutionary process by drawing a statutory bright line test to distinguish between forward and futures contracts, there are significant policy reasons why such an approach might not be desirable. First, the process by which common law develops over time tends to weed out those legal doctrines that are unfit or out-of-step with prevailing consensus as inefficient outcomes tend to be relitigated until the courts get it right. See e.g., Paul Rubin, *Why Is the Common Law Efficient?*, 6 *J. Legal Stud.* 51 (1977); George Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 *J. Legal Stud.* 65 (1977). Although we believe that the court erred in *Zelener*, for example, the overall approach of the Seventh Circuit in that matter and in the Nagel decision, in our view, does not preclude a better outcome in the future under the right set of circumstances.

Second, the evolutionary character of this process may be better suited than a fixed statutory definition to accommodate changes in marketplace as new financial products are developed. Third, a statutory definition that is poorly drafted could stifle innovation or favor one segment of the financial industry over another and thus hamper the growth and proper functioning of our commodity markets in the future. While innovators need and deserve greater clarity so that they can determine the boundaries between cash contracts (such as spot and forward contracts) that are generally outside the CFTC's jurisdiction and futures contracts that are subject to the Commission's exclusive jurisdiction, any attempt to draw a line by legislation during a period of reauthorization is subject to considerable risk.

Both the Commission and the judiciary are well-positioned to provide appropriate and ongoing guidance on the difference between forward contracts and futures contracts as the markets evolve. The problems that occur in the market for retail foreign exchange can be addressed separately by clarifying the CFTC's antifraud authority with respect to such transactions. Such a remedy would properly target the problem of fraud in that market without necessitating any statutory definitions of the terms forwards or futures.

Is CFTC participating in what I understand is an industry effort to arrive at an effective, consensus recommendation for language that would address the *Zelener* case?

Yes, the Commission is participating in discussions with representatives of various segments of the futures and derivatives industries and the National Futures Association, as well as the members of the President's Working Group on Financial Markets, in an effort to arrive at a consensus recommendation for legislative language that would address the *Zelener* decision. As stated earlier, although *Zelener* does not foreclose the possibility that the Commission may succeed in asserting jurisdiction over *Zelener*-type contracts by introducing evidence that the right to offset was implied or guaranteed during the solicitation process, the Commission welcomes any assistance that Congress may be able to provide to strengthen its authority to prosecute unscrupulous purveyors of fraudulent futures and options schemes who prey on the retail public.

The existence of boiler room operations that fraudulently guarantee large returns on investments in commodities with little or no risk to the capital invested continues to be a serious national problem. Although State and other Federal authorities have some ability to prosecute this activity, the CFTC is in the best position to track the movements of boiler room operators from State to State, or abroad, and has the broadest powers to find and freeze customer funds and to seek the assistance of foreign authorities when necessary.

The Commission recognizes that any amendment to the act must be carefully drawn and considered to guard against any unintended consequences. We believe that with the help of the industry, we will be able to submit a specific legislative proposal that will appropriately clarify our enforcement powers in this area.

OTC AND EXCHANGE-TRADED ENERGY DERIVATIVES

You discussed the Commission's success in settling the cases in the aftermath of Enron's demise, but your statement is a little less clear to me about the results of those cases. Could you please assess for me how those cases affected—in a positive or negative way—the Commission's authority, especially in light of section 2(g) dealing with excluded swap transactions and 2(h) dealing with exempt commodities? My interest is whether or not any of the companies the CFTC sued argued that their activities were protected by either of these two provisions of the act.

Since 2002, the Commission has prosecuted almost fifty entities and individuals who committed illegal acts while operating in the energy sector. As a result of those efforts, the Commission assessed close to \$300 million in civil penalties. More importantly, the Commission's actions helped uncover and reform industry-wide systemic abuse of the trade press and natural gas markets.

Throughout our investigations into false reporting and attempted manipulation with respect to natural gas, the Commission faced some jurisdictional opposition from the targeted entities. Most companies understood that the Commission was not attempting to interfere with their transactions in natural gas, but instead, was attempting to identify, sanction and stamp out the negative effects other illegal activities had on those transactions. To that end, several companies requested meetings with the Commission to provide information relevant to the investigations and gain a better understanding of how repetition of the violative conduct could be avoided in the future.

The Commission charged 27 companies and nineteen individuals for wash trading, false reporting, attempted manipulation, and/or manipulation. Of the individuals and companies that challenged the Commission's authority under the act, a handful made the argument that the conduct in question was beyond our statutory grasp by virtue of its relationship to transactions in exempt commodities that fall largely outside the jurisdiction of the Commission by reason of exemptions and exclusions under sections 2(g) and 2(h) of the act.¹

As the factual scenarios in all energy matters the Commission pursued, and as enunciated by Federal courts to have ruled on the subject, price reporting to industry publications and attempted manipulation are activities that do not further the execution or completion of energy contracts, and in many instances, is conduct that occurs even in the absence of actual contracts. Therefore, the exemptions and exclusions introduced by the CFMA do not seem to controvert the Commission's ability under the act to promote market integrity through enforcement actions.

When you talk about "additional guidance" regarding authority over fraud in your testimony about the energy markets, I assume you mean the "for or on behalf" of language contained in section 4b? Is there a reason the Commission has not specifically asked this Committee for that change, especially since I believe it was in the Senate energy bill?

Senior staff at the Commission previously consulted with Senate staff on this issue and reached a consensus on the language that was ultimately placed into the energy bill. The Commission remains supportive of the changes and has consulted with industry sources to assure that the language previously contained in the bill remains relevant. We will indeed provide guidance on specific language that will clarify the application of our fraud statute to non principal-agent relationships. Without such changes, although certain sections of section 2h preserve authority to bring fraud claims, the Commission could not pursue those claims as part of its prosecution of illegal conduct in the energy sector, since the transactions that occur in that sector do not embody a principal-agent relationship.

As you know, there has been some interest in the managed money activity on the New York Mercantile Exchange's Henry Hub natural gas futures market. The complaint has been that funds are taking excessive speculative positions that are causing market volatility and that there is no transparency in these markets. How would you respond to these complaints?

First, analysis by Commission staff has found that price volatility in natural gas appears to have been principally caused by demand and supply characteristics inherent to the natural gas market—i.e., both demand and supply of natural gas are

¹ See CFTC v. NRG Energy, Inc., No. 04-cv-3090 MJD/JGL (D.Minn. filed July 1, 2004)(charged false reporting; litigation pending); In re Mirant, CFTC Docket No. 05-05 (CFTC filed December 6, 2004)(charged false reporting and attempted manipulation; settled for \$12,500,000).

highly price inelastic in the short run—rather than the activity of managed money traders or other speculators in energy markets. During cold winter weather, demand for natural gas for space heating remains high even in the face of sharply rising prices, and very little additional supply can be made available in the short run even in response to higher prices. Faced with these rigidities of supply and demand, large price increases can occur during the winter as a result of demand spikes caused by unusually cold weather. Both academic research and market observation have shown that markets with very tight demand/supply balances tend to demonstrate high price volatility.

Second, futures markets are in fact quite transparent, especially to the CFTC. All trading activity is observable by the trading public, and prices, trading volume, and open interest are widely disseminated to the public. It is true that the identity of traders is not publicly disseminated, but it is known by the Commission. The Commission closely monitors trading activity in the natural gas futures market through our market surveillance program. The primary purpose of this program is to detect and prevent instances of possible price manipulation. The CFTC's surveillance staff receive daily reports from futures commission merchants identifying all large long and short positions in natural gas futures and options-on-futures markets.²

This reporting requirement, of course, includes positions held by professionally managed money traders. Using these reports, CFTC economists monitor trading activity in the natural gas market, looking for large positions and large trading that might be used to manipulate natural gas prices. In addition, our analysts monitor prices and price relationships, looking for price distortions that might be evidence of manipulation. They also maintain close awareness of supply and demand factors and other developments in the natural gas market through review of trade publications, and through industry and exchange contacts. Our surveillance staff routinely reports to the Commission on surveillance activities at regular weekly surveillance meetings.

Third, based on our surveillance experience with managed money traders we have not identified this trading as a source of concern. The Commission's market surveillance staff, using its large-trader reporting system, closely monitors managed money trading in natural gas, both individually by trader, and as a group. Individual managed money trader positions are generally not large compared to the size of the total open interest in the market. We have had no manipulation or congestion concerns with respect to managed money trading, since they normally roll their positions into forward contract months well before expiration. Moreover, the net aggregate position of the group is usually not extremely large in comparison to the size of the market. In fact, a substantial portion of managed money trading in natural gas involves spread trading, i.e., offsetting long and short positions in futures and/or options in order to arbitrage price differentials. This type of trading tends to be neutral with regard to the direction of prices and to price volatility.

Finally, it should be noted that speculators provide a valuable service to futures markets by providing liquidity to hedgers in the market. Liquidity can generally be described as a measure of the ability to buy and sell futures contracts quickly, and without materially affecting the market price. Liquidity is important to hedgers who need to establish hedge positions quickly and with little price slippage. Frequently, a hedger with an opposite need is not available to provide a counterparty at that moment. The participation of speculators willing to take the other side of hedgers' trades adds liquidity and makes it easier for hedgers to hedge their exposure. The Commission's Office of Chief Economist has been studying the role of managed money trading in a number of futures markets, including in natural gas. They have found, and it corroborates our surveillance observation, that managed money traders as a group generally take positions in the opposite direction of commercial traders. This finding appears to be consistent with the classic view of speculators as providing a ready counterparty to commercial trader activity.

Could you explain or provide for the record a comparison of the Commission's regulatory program for major amendments to an exchange's rules prior to CFMA and following enactment of the 2000 amendments.

Prior to the enactment of the CFMA, exchanges were required to obtain prior Commission approval before implementing amendments to an exchange's rules. Commission staff reviewed all major amendments to exchange rules, frequently worked with exchange staffs to ensure that rule amendments complied with the

² Positions in all accounts carried through futures commission merchants, foreign brokers, and clearing members that equal or exceed certain reporting levels (which vary by commodity market) must be reported daily to the Commission. The current reporting level for natural gas futures is 200 contracts.

CEA and the Commission's regulations and policies, and then recommended approval if the amendments were consistent with the CEA and the Commission's regulations and policies.

The CFMA modified the act to permit exchanges, with one exception noted below, to adopt major amendments to their rules without prior Commission approval. Instead, exchanges need only file a written notification with the Commission certifying that the rule amendment complies with the act and the Commission's regulations. The notice must be filed no later than the day before the exchange plans to list the contract for trading. In addition, the CEA provides that an exchange voluntarily may request Commission approval of a rule amendment.

There is one exception to the certification provision noted above. Specifically, the CEA specifies that exchanges must submit for the Commission's prior approval rule changes that are to be applied to open positions and that materially change the terms and conditions of futures and option contracts on certain agricultural commodities that are specifically enumerated in section 1a(4) of the act.

For rule changes filed under certification procedures, consistent with the Commission's oversight role, Commission staff conducts due diligence reviews of the filings to ensure that the rule changes meet the requirements of the act and the Commission's regulations. If any deficiencies or potential violations are identified, Commission staff works with exchange staff to address these matters. For rule amendments submitted for approval, staff conducts the same analysis that was performed prior to enactment of the CFMA to ensure that the standards for approval are met.

Could you also provide to us for the record the CFTC's authorities for trade practice and rule enforcement reviews of the exchanges' self-regulatory program?

Section 3(b) of the act provides, in part, that it is the purpose of the act to serve the public interest through a system of self-regulation "under the oversight of the Commission." Section 5(d) states that an exchange must comply with the core principles enumerated in section 5(d) of the act to maintain its designation as a contract market. Based on many years of experience, the Commission has found that trade practice and rule enforcement reviews are very effective oversight tools to ensure that the exchanges continue to comply with all statutory requirements, including the core principles, as well as Commission regulations and policies applicable to futures exchanges.

SECURITIES FUTURES PRODUCTS

You mention in your statement the double regulation of notice registrants for purposes of security futures contracts. Didn't the law specifically mandate that when a futures exchange provides a notice registration to trade security futures and the registration is accepted by the SEC then the futures exchange would be exempt from other regulatory provisions, such as SEC audits?

It is correct that the CFMA provides for "notice registration" with the SEC of designated contract markets, derivatives transaction execution facilities and futures market intermediaries that trade security futures products (SFPs).³

The intent of the notice registration provisions was to avoid unnecessary and overly burdensome dual registration of exchanges and intermediaries. The CFMA did not, in fact, exempt notice-registered futures exchanges from all SEC audits and examinations.⁴

The CFMA provides that notice-registered futures exchanges shall not be subject to "routine periodic examinations" by the SEC. It further requires cooperative efforts by the SEC and CFTC to "avoid unnecessary regulatory duplication or undue regulatory burdens"⁵

The SEC and CFTC entered into a Memorandum of Understanding (MOU) on March 14, 2004 with respect to notice registrants and information sharing. The MOU requires that the agencies notify each other regarding any planned examina-

³ The CFMA also provides for "notice registration" with the CFTC of national securities exchanges, and SEC-registered broker/dealers.

⁴ The CFMA lists specific exemptions from certain provisions of the Securities Exchange Act of 1934 relating to, among other things, requirements regarding exchange rules, registration procedures for self-regulatory organizations, and trading by members of exchanges.

⁵ Section 17(b)(1)(B) of the Securities Exchange Act of 1934, 15 U.S.C. 78q(b)(1)(B), on notice-registered exchanges. In addition, the CFMA requires that the SEC notify the CFTC of any examination of a notice-registered futures exchange, furnish reports to the CFTC upon request, and, prior to conducting examinations of notice-registered exchanges, and use CFTC reports of examinations if the information available is sufficient for the purposes of the examinations.

tion, advise each other of the reasons for examinations, provide exam-related information to each other, and conduct joint examinations when feasible. Also, the MOU provides that the agencies will keep each other apprised of significant issues in SFP markets and share trading data and related SFP information.

SEC staff have identified seven types of examinations that it undertakes regarding exchanges and intermediaries, specifically:⁶

- “routine periodic” examinations
- “for cause” examinations
- “oversight” examinations (review SROs to ensure that their routine periodic examination of broker/dealers is sufficient)
- “focused examinations” (focus on one area of SEC’s examination modules)
- “exam sweeps” (focus on a particular issue across a large number of firms)
- “series of examinations” (similar to sweeps, but with a smaller number of firms)
- “surveillance examinations” (review of a particular broker/dealer to survey activity)

While the last four listed examinations relate primarily to intermediaries, SEC staff have indicated that they may do similar examinations for exchanges, and have also stated that they may undertake “special purpose market examinations” of notice-registered futures exchanges. We believe Congress should clarify that the SEC’s authority to examine CFTC-designated exchanges is specifically limited to “for cause” situations only and none of the other examination categories. Such a change would eliminate overlapping and unnecessary review of exchanges that are already subject to primary oversight by the CFTC.

Another significant area of concern relating to dual market oversight relates to the SEC’s unilateral ability to abrogate rules of notice-registered futures exchanges. Abrogation means that the SEC staff can unilaterally void a notice-registered futures exchange’s rule. Abrogation of a notice-registered futures exchange’s rule, except in extraordinary situations, is inconsistent with the intent underlying the CFMA to avoid prescriptive regulation. For example, the Chicago Mercantile Exchange had proposed rules to facilitate the listing and trading of SFPs, but chose not to pursue this effort based on assertions by SEC staff that they would abrogate a proposed rule unless it was changed pursuant to SEC staff instructions; SEC did not consult with the CFTC in this process.

What are the margin requirements for security futures products and how could portfolio margining provide some relief for current margin requirements? Before you answer that question, it might be good if you could describe the difference between futures margins and security margins.

Security margins serve as a down payment of the intended purchase of a security. Typically, an investor is required to post at least 50 percent of the security’s value in margin when purchasing a security. Futures margins, by contrast, serve as a performance bond on the contract and are set to ensure that the customer who has entered into the contract can meet potential short-run losses on the contract. Exchanges typically set futures margins to cover 99 percent of the daily price moves, usually 3 percent to 7 percent of contract value, over a specified time period. In addition, as prices move against a customer’s position, they will be expected to post additional margin to cover future potential losses.

The margin requirements imposed upon security futures products (SFPs) are by law set in reference to margins on stock options. These margins, which are currently set at 20 percent of contract value, function more like security margins in that they are fixed and do not explicitly take into consideration the underlying financial risk of the contract. While the margins are lower than that set for the purchase of securities, they are significantly higher than those on futures contracts or options on futures contracts, and greater than required to manage short-term financial risk.

The margin requirements imposed upon SFPs differ in two major respects from those on other futures contracts. First, an individual security future is subject to securities-style margin of 20 percent, rather than futures-style, risk-based margining of between 3 percent and 7 percent. Second, SFPs are denied portfolio margining treatment available to other futures (and, which the SEC may soon make available for security index options, but not security futures). Under risk-based portfolio margining, required margin depends on analysis of the risk of each position in a customer account and recognition of risk offsets among correlated positions. In the U.S., the SPAN (Standard Portfolio Analysis of Risk) portfolio margining system, devel-

⁶ These examinations are not defined in securities statutes or regulations, but rather are developed by SEC staff practice, and may be changed as staff determines necessary.

oped by the CME and licensed around the world, is used to calculate margin for futures contracts.

Unlike other futures, SFPs are restricted to a relatively limited set of “strategy-based offsets” that are currently permitted for security options. These can ameliorate some of the economic imprecision inherent in fixed-percentage margining, but do not reflect economic risk nearly as well as would risk-based portfolio margining.

The benefits of portfolio margining among different types of financial contracts on different exchanges are widely recognized. Portfolio-margining allows much greater capital efficiency for the businesses and investors that use derivatives to manage risk. This, in turn, can encourage even better and more widespread use of derivative-based risk management. From a supervisory perspective, it is well recognized that offsetting positions in an appropriate cross-margining arrangement often provide even better protection for firms and clearinghouses than traditional collateral.

Back in 2000 when we enacted the CFMA, the idea was to allow both futures exchanges and equity exchanges to sell single stock futures and to basically look to their own respective primary regulator—the CFTC or SEC—to govern their single stock trading. The two agencies were supposed to coordinate their activity of single stock futures has been greeted with only modest success, in some degree due to continuing regulatory uncertainties and regulatory duplication between the two relevant agencies. Can you tell us what the state of play is on single stock futures with respect to progress in working out the respective regulatory regimes applied by CFTC and SEC?

We have had some success working cooperatively with the SEC regarding oversight of exchanges and intermediaries, however, issues remain. The agencies entered into an MOU on March 14, 2004, regarding sharing SFP examination-related information, and intended the MOU to ensure effective supervision of these markets and at the same time avoid duplicative and unnecessary oversight. As noted in a previous answer, however, it may be appropriate for Congress to review the specific types of examinations undertaken of notice-registered exchanges to ensure that they do not result in unnecessary dual oversight. In addition, Congressional review of the SEC’s unilateral rule abrogation authority may be appropriate.

Two other areas where further progress is necessary are SFP margins and futures on foreign security indices. First, a legislative change to the SFP margin level should be considered; currently the level of SFP margins is statutorily set to be “consistent with comparable options” and not “lower than the lowest level of margin . . . required for any comparable option . . .”⁷

Market participants have commented that the margin level is unnecessarily high, does not reflect the amount of risk involved, and discourages trading in SFPs. Second, a more flexible risk-based, futures-style portfolio margining system is appropriate for these products. The implementation of portfolio margining could yield more users and more liquidity for SFP products, and thus greater success for these markets. Third, as required by Congress in the CFMA, the agencies must jointly adopt rules that would permit U.S. customers to trade futures on foreign broad-based securities indices; and fourth, the agencies must engage in the same mandated undertaking regarding foreign narrow-based securities indices. To date the CFTC has met with resistance on the issue of foreign-based security indices and no progress has been made.

We note that, to date, there have only been two exchanges notice-registered with the SEC to trade SFPs, and one of them ceased trading operations in December 2004. Market participants have commented that dual regulatory burdens have contributed in large part to the low level of trading and interest in these products.

What are the remaining problems or impediments that you see or which the industry has raised with regard to regulation of single stock futures?

Security Futures Products (SFPs) are denied the benefit of portfolio margining that is available to other futures contracts. Moreover, recent initiatives being considered by SEC staff would extend portfolio margining to certain security index options but not to security futures, which could create regulatory and competitive disparities against SFPs.

The act designates the Federal Reserve (Fed) as the agency responsible for setting margin, which they have delegated to the CFTC and SEC. In delegating jointly to the CFTC and SEC responsibility for developing appropriate margin rules for SFPs, the Fed requested that “the Commissions provide an assessment of progress toward adopting more risk-sensitive, portfolio-based approaches to margining security fu-

⁷ Section 7(c)(2)(B) of the Securities Exchange Act of 1934, 15 U.S.C. 78(g).

tures products” in furtherance of the Fed’s own actions, such as amending its Regulation T so that portfolio margining systems “can be used in lieu of the strategy-based system.” The Fed also stated that it “anticipates that the creation of security future products will provide another opportunity to develop more risk-sensitive, portfolio based approaches for all securities, including security options and security futures products.”

The SEC publicly endorsed the Fed’s position, stating in the Federal Register release for the final customer margin rules, that “[t]he Commissions strongly encourage the efforts of market participants to develop a portfolio margining proposal for security futures, and are committed to working with these participants to resolve any outstanding issues as quickly as feasible. Such a portfolio margining system would be in keeping with current practices in the futures industry and would be responsive to the Fed’s desire to encourage the development of more risk-sensitive, portfolio-based approaches to margining security futures products.”

Nonetheless, there has been no real progress toward portfolio margining for SFPs, only for certain security index options. In 2004, CFTC staff told the Fed that this “lack of progress is disappointing.” The Fed responded that it “recognizes that progress in this area is outside the control of the [CFTC]” and that it “appreciates the [CFTC’s] willingness to lend its expertise.”

In sum, then, the SEC staff was apparently only willing to permit SFPs to trade on terms that would deem them securities and futures, giving the SEC regulatory authority over them and subjecting them to terms and conditions fitting the securities regulatory scheme. This framework, particularly the margin standards, has made SFPs unattractive to many customers and severely limited the ability of SFP markets to achieve critical mass.

And that intransigence is a cause for serious concern on related issues. Unless the staffs of the CFTC and SEC both demonstrate a consistent and reciprocal willingness to work together to satisfy their respective supervisory concerns in a way that does not stifle much-needed innovation and competition in the U.S. financial markets, U.S. markets may fall behind in their efficiency, effectiveness, and safety. For example, as it continues to review a proposed pilot program for portfolio margining and cross-margining of securities and traditional (non-SFP) futures that was initially filed by the Chicago Board Options Exchange more than three years ago, the SEC staff is taking the position that a strictly securities-style framework must be imposed upon this arrangement.

Although the existing limited cross-margining arrangement for CME stock index futures and CBOE security index options has been operating successfully for many years, and although market participants would like to see it expanded, SEC staff have unilaterally indicated that they will not permit this unless significant changes are imposed, such as requiring that all positions, both futures and options, be held in a securities account instead of a segregated customer funds futures account, as has been the case to date. This unilateral decision to impose a mandatory change in the type of account utilized would impose substantial operational costs on market participants, would disadvantage some market participants relative to others, and could call into question key protections upon which CFTC relies for ensuring market integrity and customer protection in the futures markets.

AGRICULTURAL PRODUCTS

In the spirit of the CFMA, the Commission has worked to move markets toward greater self-regulation. Specifically, in agriculture, this movement has been successful and has resulted in a stronger, more open and more transparent marketplace. Despite this progress, agricultural commodities continue to receive special consideration not given to other commodities. While embracing the spirit of the CFMA, why does the Commission continue to support this distinction?

In enacting the CFMA, Congress continued to treat the agricultural sector differently in certain areas. Certainly, many of the advances of the regulatory approach of the CFMA play a role in the agricultural derivative markets, but there is no denying that some of the most significant changes have not been applied to agricultural commodities. The Commission stands ready to work with Congress and the agricultural industry to examine further modifications of the statute that would be beneficial for this important sector of our Nation’s economy.

The CFMA pushes the Commission to remove unnecessary regulatory obstacles to market operation. Over the last four years, the Commission has worked toward this goal, but still producers are blocked from using the agricultural trade option pilot program. What are your thoughts on how the

Commission can make this program a commercially viable risk-management option for producers as we move forward under the CFMA?

After conducting a thorough review of the cost and benefits that the offer and sale of agricultural trade options (ATOs) would provide to the agricultural sector, the Commission lifted the ban on ATOs on June 15, 1998. The rules allow the offer and sale of trade options on agricultural commodities which had been prohibited since 1936. In addition, the Commission sought out the guidance and opinions of various segments of the agricultural community and the futures and options industry. This was accomplished through various Commission hearings, roundtable discussions and comment letters received in response to rulemaking notices.

The rules adopted by the Commission best represented the consensus of interested parties with respect to lifting a ban that had existed for more than a half century. In response to continuing concern regarding the workability of the rules, the Commission revised them in 1999 to streamline regulatory and paperwork burdens. In addition, the Commission amended the rules to permit for the cash settlement and offset or cancellation of ATOs. These changes were adopted after giving careful consideration to extensive comments received from all segments of the agricultural community and the futures and options industry. Since the adoption of the rule changes in 1999, however, only one company has registered as an Agricultural Trade Option Merchant and offers ATOs subject to the ATO rules.

The topic of ATOs and the rules governing them was the subject of a CFTC Agricultural Advisory Committee meeting in March 2001. The Committee engaged in a wide-ranging discussion regarding the current use of ATOs and desired changes in the rules. A consensus in views regarding the rules and potential changes in them did not exist among the participants. Clearly, we must satisfy the concerns of farmers and producer groups and ensure that regulations effectively protect their interests without stifling the offering of this important risk management product to the agricultural market. The Commission remains committed to providing agricultural producers with safe access to risk management tools and continues to monitor and review the situation with respect to ATOs.

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

WEDNESDAY, MARCH 9, 2005

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

The subcommittee met, pursuant to call, at 10:05 a.m., in room 1302 Longworth House Office Building, Hon. Jerry Moran (chairman of the subcommittee) presiding.

Members present: Representatives Boehner, Neugebauer, Goodlatte [ex officio], Etheridge, Salazar, Marshall, Melancon, Boswell, Larsen, Chandler, Costa, and Peterson [ex officio].

Staff present: Dave Ebersole, Kevin Kramp, Tyler Wegmeyer, Callista Gingrich, clerk; Matt Smith, and John Riley.

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

Mr. MORAN. Good morning, everyone. Welcome to our Subcommittee on Farm Commodities and Risk Management. I apologize for the slightly less than accommodating meeting room. Normally, Members of Congress are troubled by a number of meetings at the same time, but normally not the same committee meeting at the same time—the Agriculture Committee is meeting in 1300 today regarding the WTO issues. We are here, again, to review the Commodity Futures Modernization Act of 2000 to see what has worked well and determine what changes, if any, might be recommended as we proceed to reauthorize this legislation.

Last week, in our first hearing on this topic, we heard from Dr. Sharon Brown-Hruska, the acting chairman of the CFTC. Today, I am pleased that we are going to hear from three panels of exchanges and associations who have a stake in the legislation that this subcommittee will develop. It is my general practice that a subcommittee hearing should not last more than an hour, an hour-and-a-half. That would suggest that the first panel may consume all of the time. We will try to avoid that, and I would ask that our witnesses make their remarks within the 5-minute allotted time, and I will try to give everyone an opportunity to speak and members of the subcommittee to respond and ask questions.

This hearing will last longer than my usual practice, but rather than being here for 2 or 3 days, we thought we would confine this meeting to this morning and perhaps early this afternoon.

Technological changes have allowed the futures industry and option market to grow and evolve into a round-the-clock, global industry. Past legislative changes have allowed new products, such as single-stock futures, to be introduced, giving solid legal footing to existing products, and reflected the regulatory requirements of internationally competitive markets for risk-management products.

In the over 4 years since the passage of CFMA, futures markets have grown and developed tremendously, as well as faced some difficulties and challenges. Today, the subcommittee continues its review of the futures industry by listening to the leaders of that industry. We have a relatively new number of members on this subcommittee, to whom these issues will be somewhat new, and it has been quite some time since the rest of us have worked on these issues as well, so we look forward to the education that the distinguished panel of witnesses will be able to provide to our subcommittee members today.

I now turn to the distinguished gentleman from North Carolina, Mr. Etheridge.

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

Mr. ETHERIDGE. Thank you, Mr. Chairman, and let me thank you for holding this hearing today. My numbers indicate we have 14 witnesses. If each one takes 5 minutes, that is 70 minutes, so the less I say, the sooner we can get to the testimony, so let us get going. Thank you.

Mr. MORAN. You have upstaged the chairman. We now, will hear from those witnesses, and I would like to invite the panel that is at the table to begin their testimony. Mr. Terrence A. Duffy, who is the chairman of the Chicago Mercantile Exchange Holdings, Inc. in Chicago, IL; Mr. Charles Carey, the chairman of the Chicago Board of Trade, Chicago, IL; Dr. James Newsome, president of the New York Mercantile Exchange, New York, NY; Mr. Frederick W. Schoenhut, chairman of the New York Board of Trade, New York, NY; and Satish Nandapurkar, chief executive officer of Eurex U.S., Chicago, IL. Mr. Duffy, we are ready to begin.

STATEMENT OF TERRENCE A. DUFFY, CHAIRMAN, CHICAGO MERCANTILE EXCHANGE HOLDINGS, INC., CHICAGO, IL

Mr. DUFFY. I am happy to appear before you, Chairman Moran, to offer the subcommittee the CME's view as to what the subcommittee should be considering as it undertakes reauthorization of the CFTC. In the judgment of the CME, the Commodity Futures Modernization Act of 2000 represents successful, landmark legislation that materially and beneficially transformed the nation's futures markets. The CFMA facilitated reduction of high-cost regulation, and has been an unparalleled success, making futures trading more efficient and useful to a wide range of customers.

Throughout its over 100-year history, and especially so in the past three decades, the CME has earned a reputation as a premier innovator and industry pacesetter. A very clear demonstration of our leadership in the global derivatives industry is an historic clearing link between the CME and the Chicago Board of Trade,

which has delivered on the efficiencies and \$1.8 billion in savings just as promised.

Within our organization, the initials “CME” stands for “Customer Means Everything,” and I think that customer-driven perspective explains much in terms of our success since the enactment of the CFMA. While the CME enthusiastically applauds the success of the CFMA and recommends that we retain its historic, statutory framework, the upcoming congressional reauthorization process offers a valuable opportunity to fine tune that statutory regime based on industry experience gained since the CFMA’s enactment in 2000.

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

Compounding this problem is the recent, unfortunate decision of the 7th Circuit Court of Appeals. In *CFTC v. Zelener*, the court adopted an extremely narrow definition of futures contracts. *Zelener* held that a futures contract stopped being a futures contract if the seller inserted a meaningless disclaimer. The ruling permits OTC dealers to easily offer futures-like contracts to unsophisticated customers without CFTC jurisdiction or registration requirements.

As noted in recent testimony by Acting Chairman Brown-Hruska, this retail fraud has spread from foreign-exchange scams to heating oil and orange juice. This can and should be stopped by closing the loophole created by *Zelener*. Unless the loophole is closed, the committee should be concerned with the very real prospect that before long, the CFTC’s jurisdiction and its retail customer protections may be reduced to irrelevance. The challenge for the committee and the futures industry is to find an effective solution that will politically survive the reauthorization process.

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

Before concluding, Mr. Chairman, I noted that one of the witnesses called on Congress to force exchanges that innovate and pioneer new contracts, to freely give up the benefits of their investment in innovation to their competitors. That idea is utterly contrary to every viable economic principal that has made the U.S. economy work. A number of other issues have been raised in written testimony. I will be pleased to explain why self-regulation in the futures industry works, how our corporate governance meets the highest standards, and why the rule-making process under the

CFMA is not broken, in response to your questions or in supplemental testimony.

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

[The prepared statement of Mr. Duffy appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Duffy, thank you very much for being here today. The Chair now recognizes Mr. Carey.

**STATEMENT OF CHARLES CAREY, CHAIRMAN, CHICAGO
BOARD OF TRADE, CHICAGO, IL**

Mr. CAREY. Mr. Chairman and members of the committee, my name is Charles Carey, and I am chairman of the Chicago Board of Trade. It is an honor for me to appear before you to present the Board of Trade's views. As you have requested, we have submitted our written testimony for the record.

We commend Congress for its excellent work in passing the Commodity Futures Modernization Act and the careful and thoughtful way in which the Commodities Futures Trading Commission has implemented its provisions.

The CFMA gave the commission needed flexibility to deal with innovation and brought legal certainty to many products while preserving regulatory concepts that are essential to our industry. The commission and its staff have shown great insight in using this authority to reduce regulatory burdens without sacrificing vital customer protections.

In my written testimony, I call attention to several issues that deserve discussion, but major changes to the law appear unnecessary at this time. For example, security futures, which were allowed for the first time by the 2000 act, have yet to reach their potential. Dual regulation by the CFTC and the Securities and Exchange Commission has created challenges. We hope two commissions work together to relieve these, such as the unfair and unnecessary margin inequities that inhibit the growth of stock futures and their usefulness as risk-management tools. A Federal Court decision holding that the CFTC has no anti-fraud jurisdiction over retail foreign currency transactions could lead to increased opportunities for fraud.

The potential impact of this decision is a matter of concern across the futures industry. Congress may find that this issue warrants a legislative response. If that is the case, the CBOT will, as always, be happy to work with the committee, the commission, and other industry representatives in creating a solution. Since the CFMA, a major trend in the industry has emerged toward international expansion and cross-border business arrangements. This trend presents interesting challenges for regulators at home and abroad. In one such initiative, Eurex, soon, will ask the CFTC to

approve a plan to clear trades on its U.S. subsidiary contract market through a clearinghouse located in Frankfurt, beyond the regulatory control of the CFTC. The CBOT believes that such a non-domestic clearinghouse should register with the CFTC as a designated clearing organization. The requirement that U.S. futures should be cleared by DCOs is good regulatory policy and would preserve that U.S. citizens trading on Eurex U.S. the protections available under U.S. regulation and bankruptcy law in the event of a default or insolvency.

Recent actions of a handful of traders in London, selling and buying bonds through a European electronic trading system, are being investigated by four European governments for possible price manipulation. This incident illustrates the potentially destabilizing effect that market behavior can have across borders and between exchanges and marketplaces. Comparable regulation and information collection among regulators of different countries is essential to help detect and prevent systemic harm from such activities. The CBOT is pleased that the CFTC recently began discussions with the committee of European securities regulators and hopes those discussions will be productive in resolving issues of regulatory disparities and gaps, in a manner consistent with the CFMA.

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

The Chicago Board of Trade, the oldest and one of the largest futures exchanges in the world, had its best year ever last year, trading over 600 million contracts, a volume increase of over 31 percent from the prior year. The success of the Chicago Board of Trade over the years reflects the confidence that market participants have in our commitment to vigorous, evenhanded self-regulation. Self-regulation with commission oversight continues to work well. There have been questions raised concerning the move by exchanges to become for-profit organizations and whether they can avoid conflicts of interest. A for-profit exchange has an even greater incentive to maintain and increase public confidence. Experience has shown that investors prefer markets that have demonstrated integrity through self-regulation. The Chicago Board of Trade is presently going through the process of becoming a for-profit organization, and I assure the committee that this new status, while enabling us to compete more efficiently with other exchanges from around the globe, will not lessen our dedication to fair and forceful self-regulation.

We hope and expect that regulators will keep in mind the advantages of knowledgeable and experienced self-regulation and not impose rigid definition that, for example, may preclude a member of an exchange with no other ties to the exchange from becoming an independent director or a committee member. Again, thank you for the opportunity to testify today. The Chicago Board of Trade is pleased to respond to questions and provide any assistance the committee may deem necessary. Thank you.

[The prepared statement of Mr. Carey appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Carey, thank you for your time. Dr. Newsome, welcome back in a new capacity.

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

Mr. NEWSOME. Thank you Mr. Chairman. Members of the committee, it is an honor to be here this morning as president of the New York Mercantile Exchange. NYMEX is the world's largest forum for trading and clearing physical commodity-based futures contracts, primarily energy and metals. The CFMA of 2000 was landmark legislation that provided critically needed legal certainty and regulatory flexibility to U.S. futures exchanges and derivatives markets. It is our view that the current structure is providing a reasonable, workable, and effective oversight regime for the regulated exchanges. Prior to the CFMA, the CFTC operated under a one-size-fits-all regulatory approach. Regulatory inequities, particularly buyer-approval requirements for rule and contract changes imposed unreasonable constraints on domestic exchanges competing with both international and unregulated exchanges.

This committee and the Congress agreed that the orientation of the CFTC should be shifted to a more flexible oversight role to address these issues. Congress established market tiers so that a marketplace can now select a level of regulation according to the product types offered, but more importantly, to the eligible participants for the facility. NYMEX operates, by choice, at the highest level of regulation by CFTC and has been consistently deemed by CFTC staff reviews to have maintained adequate regulatory oversight and programs.

Although NYMEX is largely a marketplace used by commercial participants for hedging, the benefits also accrue more broadly to consumers, who receive prices based on open and fair competition. Prices for the commodities traded in U.S. futures markets are vital to our national economy and are recognized as reliable global benchmarks. As a note, the CFMA maintains the CFTC's exclusive jurisdiction over futures and options on futures. NYMEX supported and continues to support this approach, which would be maintained by several savings clauses contained in last year's energy bill.

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

Regulatory flexibility was vital in responding to the financial failure of Enron. In the aftermath, other energy-trading companies lost credit rating, stock prices plummeted, and liquidity crises began to develop because market participants lacked confidence in each others' abilities to perform transactions. In response, NYMEX addressed these issues by rapidly implementing a number of important measures to migrate positions from over-the-counter market-

place to NYMEX and the protections provided by it is AA+-rated clearinghouse.

NYMEX also began launching a slate of products appealing to OTC participants, which are executed off the exchange, but brought to NYMEX for clearing. In doing so, 130 products that are traditionally traded OTC have been brought under the umbrella of a regulated exchange which establishes the identity of participants, a transaction audit trail, daily precision surveillance, and security credit, none of which would have been available prior to the CFMA.

We recently completed an analysis of hedge fund participation in several NYMEX markets, during the year 2004, which is being submitted to this committee, Mr. Chairman, for the record. As you review this report, I believe that you will agree, as our research suggests, that hedge funds serve an overall, constructive role in our marketplace. And while hedge fund participation has not made up a large portion of our markets to date, we continue to monitor this market segment closely. Market integrity continues to be effectively safeguarded on the regulated exchanges through stringent adherence to the CFMA core-principles. As a self-regulatory organization, NYMEX devotes significant resources to the oversight of all of its markets. With regard to CFTC oversight responsibilities, the agency has been, by all accounts, quite vigorous at exercising the scope of its current authority to police abuses in the OTC marketplace, including energy markets. Nonetheless, there remain open issues respecting CFTC anti-fraud authority over principal-to-principal transactions involving exempt commodities executed bilaterally or in electric platform. Congress certainly may wish to consider whether clarification or guidance in this area is needed, and NYMEX looks forward to working with the committee on that topic.

In closing, Mr. Chairman, the regulated futures industry is more robust and competitive as a result of the common-sense revisions made by Congress in the year 2000. The CFMA regulatory scheme has provided and continues to provide an orderly and secure framework for competitive risk management. Mr. Chairman, I may admit that I am a little bit biased, but I do believe that the CFTC followed closely the intent of the Congress as they implemented the CFMA. I think it is working; I think this committee should be commended for that legislation; and certainly look forward to participating and answering any questions.

[The prepared statement of Mr. Newsome appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Newsome, thank you very much. Mr. Schoenhut?

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

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

In 2004, the Coffee, Sugar, and Cocoa Exchange, founded in 1882, and the New York Cotton Exchange, founded in 1870, for-

mally became one exchange, the New York Board of Trade. Like its predecessor exchanges, NYBOT is a not-for-profit membership organization, established under New York law. NYBOT is the premier world market for futures and options in cocoa, coffee, cotton, orange juice, and sugar. The exchange also has markets in currency rates and equities indices. While the financial markets exhibit different underlying characteristics than the agricultural commodities that dominate the exchange, they all provide reliable tool for price discovery, price risk management and investment.

In 1994, NYBOT established a trading floor in Dublin, which is the first open-outcry trading facility in Europe owned by a U.S. exchange. The concept of self-regulation, long embodied in the CEA, was strongly enforced and expanded by the Commodities Futures Modernization Act of 2002. The CFMA was the culmination of 4 years of work by the Congress. It provided flexibility for exchanges to decide how to best structure their business around a set of core principals. The CFTC provides oversight rather than promulgating prescriptive regulations and second-guessing exchanges decisions. We believe the CFMA is working as intended, allowing markets to be competitive and by modernizing and streamlining the regulatory system.

We, therefore, support a reauthorization bill that continues this current regulatory structure.

In this regard, we wish to point out three areas of exchange self-regulatory structure that are important to maintain. First, each exchange should continue to be allowed to determine the composition of its governing board. Consistent with core principal 16, the NYBOT board consists of 25 voting governors and one nonvoting governor, the president, who is the sole staff-representative to the board. NYBOT governors include members who represent the commercial industries associated with products traded on the exchange, members who trade for themselves and others on the trading floor, FCMs, and public governors. This diversification provides the board with a level of expertise that can only be provided by people who are actively engaged in the trading of the products and also allows the board to take a range of views into consideration before reaching a decision. How board members are chosen, whether to have such diversification, and how representation of various communities should be allocated are matters for each designated contract market to determine for itself in light of its own particular circumstances.

Second, the structure for exchange compliance and disciplinary function should also remain unchanged. Currently each exchange is required to have procedures in place for monitoring and enforcing contract market rules. The CFTC conducts regular rule-enforcement review to determine whether an exchange is meeting this requirement. Most cases presented to our disciplinary committee are very technical in nature and require a strong knowledge of our rules and understanding of trading practices. With this system changed by requiring majority of the disciplinary committees or trial panels to be comprised of nonmembers, it would deprive the system of needed expertise. Moreover, it would be difficult to attract regular panel participants without adequate compensation, thereby placing smaller exchanges that cannot afford to pay public

members attractive sums for serving on such panels at a disadvantage.

While the NYBOT compliance has worked successfully for many years, undoubtedly other systems might be employed at other exchanges to equally good effect and should be decision of each exchange as to what system to employ. We believe the current system works well and additional requirements making the make-up of or functions of the disciplinary committees are not needed.

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

In closing, Mr. Chairman, on behalf of the Exchange, its trading community, and users, I would like to thank the CFTC, this committee, and Congress for the support they gave after 9/11. NYBOT was the only exchange completely destroyed in the World Trade Center terrorist attack. Fortunately, we had a back-up site in Long Island City, and using this site, we were able to trade 6 days later. And thanks to the assistance that Congress provided, we were able to rebuild in lower Manhattan and move to our new facilities in September 2003. In 2004, we hit new trading volume records of approximately 32 million contracts, representing a 32-percent increase from the 2003 year.

Mr. Chairman, I would be happy to answer any other questions you may have.

[The prepared statement of Mr. Schoenhut appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much. Mr. Nandapurkar.

STATEMENT OF SATISH NANDAPURKAR, CHIEF EXECUTIVE OFFICER, EUREX U.S., CHICAGO, IL

Mr. NANDAPURKAR. Chairman Moran, members of the committee, thank you for the opportunity to testify. I am Satish Nandapurkar, CEO of Eurex U.S. Eurex U.S. is very grateful for invitation to participate in these hearing and be able to present our views as a relatively new entrant in these markets.

I share the opinion of others on this panel that the CFMA has been a tremendous success. We believe it is working as Congress intended, namely by allowing exchanges more freedom to innovate and making it more attractive to operate here, on the ground, in the United States, as a U.S. regulated futures exchange.

The CFMA has facilitated a degree of competition in the U.S. markets that has never been seen before, resulting in greater innovation, greater efficiency, and greater choice for market participants. The numbers speak for themselves. Volume in the year 2000, across all U.S. futures exchanges, were 600 million contracts. Last year, volume ballooned to 1.6 billion contracts.

We are also of the opinion that the CFTC has done an outstanding job in putting into practice this groundbreaking legislation.

Starting with former Chairman Newsome, and now continuing with Acting Chairman Brown-Hruska, the CFTC has moved expeditiously, yet prudently, in implementing the new, streamline regulatory structure, while ensuring that participants are adequately protected.

Since enactment of the CFMA, the CFTC has designated eight new futures markets and eight new clearinghouses. And not surprisingly, this increase in competition has been accompanied by new products, new services, lower cost and increased efficiency. 600 new products have been filed since enactment of the CMA, and as exchanges compete, a beautiful thing happens; fees drop. When we came into the marketplace for U.S. treasuries, the incumbent exchange, CBOT, dropped their fees 80 percent, and in some cases, dropped their fees to zero, resulting in tremendous savings for the industry, and especially for users.

Competition has also forced exchanges to finally respond to customers' preferences for the transparency, immediacy, and efficiency of electronic trading. Last year, most of the futures traded in the United States were traded electronically. Back in 2000, that wasn't even close to the case. Thanks to electronic trading, a trader anywhere in the United States can be on the same footing and have access to the same information as that which was once reserved for a trader in the pits in Chicago.

We at Eurex U.S. are particularly indebted to the committee, for without the committee, there would be no Eurex U.S. If I may, I would like to tell you a little bit about Eurex U.S. We are a new futures exchange registered with the CFTC and regulated by the CFTC. We are headquartered in Chicago with a U.S. management team based in Chicago. Our clearing is handled by the Clearing Corporation, a 75-plus-year-old institution, again, based in Chicago. Market surveillance and trade-practice surveillance is provided by the NFA—the not-for-profit NFA in Chicago. We began trading in February 2004 with futures on 2-, 5-, and 10- year Treasury notes and on the 30-year Treasury bond as well as options on those futures. This year, we have expanded our product line into equity index futures with the large-cap Russell 1000 index and the small cap Russell 2000 index.

Our approach to markets is quite straightforward. We believe customers are best served by an all-electronic trading system, equal access to market information on a level playing field, and low fees for all. And we believe that people should get all of this with no membership purchase required. And our goal here is not just to compete for the market in the United States, but to expand the market in doing so. As markets continue to globalize, we plan to be on the forefront of facilitating cross-border trade, making it easier for the European customer to access U.S. market and U.S. customer to access European markets.

We have had extensive discussions with the CFTC on the implementation of the next phase of our global business plans.

In enacting the CFMA, Congress placed great faith in competition, and that faith has been rewarded. Greater innovation and greater efficiency have been the engine of growth in the futures industry in the last few years. In our own way, we are trying to realize the potential created by the CFMA. We offer the U.S. market-

place open and equal access, an all-electronic venue, competition in existing products, new products, and low fees for all. Our course forward is to build on this foundation to bring greater business into the United States. The CFMA has greatly facilitated our ability to do this. We urge Congress to stay the course. Continued reliance on the benefits of competition will transform the futures industry even future for the benefit of all and preserve the U.S.'s leadership role in the global futures industry. Thank you.

[The prepared statement of Mr. Nandapurkar appears at the conclusion of the hearing.]

Mr. MORAN. I thank you very much. In light of Mr. Boehner's schedule, the Chair now recognizes the gentleman from Ohio.

Mr. BOEHNER. Let me thank the chairman for accommodating my schedule. I have got a mark-up going on in my committee in a few minutes, and as the chairman of the committee, I probably ought to be there.

Let me suggest, as I did last week, that, having been through several of these reauthorizations of the Commodities Exchange Act, the CFMA clearly is a success, and for those of us who have sat on this committee and been through this process several times, it is probably one of the most significant achievements that members of this committee have participated in.

But what I really failed to do last week when I made this point was to thank those of you on this panel, those of you on the following panels, for your efforts in helping us achieve what has been a great success. Because if it had not been for the CFMA, given the continued globalization of the world economy, given the regulatory structure we had prior to the CFMA, heavens only know where that business would be located today. And I would suggest, clearly, not in the United States. And so as we look at the reauthorization of the Commodities Exchange Act, we are going to continue to need your help in those areas where we believe we need fine tuning. Now, fine tuning, I would point out, doesn't mean legislating an advantage for your market versus someone else—or your exchange, vis-a-vis, someone else. And I think that competition that has come to the industry has kept the U.S. industry competitive, continued to be a leader in the worldwide futures markets, and I want to see that continue. Dr. Newsome, you have played a key role in helping us put together the CFMA, and when it comes to reauthorization, can you give us 1, 2, 3 points, in your opinion, sitting in your unique position, as to what you think we need to do.

Mr. NEWSOME. Chairman Boehner, I would be more than happy to do so. I think I would start with the ability of the commission to bring charges against off-exchange forex bucket shops. In my opinion it was clearly the intent of Congress to give the CFTC that authority. That authority has been thrown into question through the *Zelener* decision that many of you have discussed.

Certainly, I am not an attorney, so from the legal aspects of the law, it would be very difficult for me to discuss. I would just say this: the decision that the court faced was a very similar decision that the commission faces on a weekly basis as we sit and listen to appeals on cases that go before our Administrative Law Judges. I don't think there was any question about the fact that there was fraud in the *Zelener* case. The question was whether it was a fu-

tures contract. The commission viewed *Zelener* as a futures contract, and we were different than the court in the fact that we looked at all of the components, not just the verbiage of the contract, but actually how it was implemented and used. And we do that very regularly, so I think that is why you have a difference in how the commission viewed the case versus how the court—who just tended to look at the verbiage in the contract and declared it was not a future.

I think, without going into trying to define exactly what a futures is, which is very, very difficult, I think guidance from the Congress with regard to how the commission and how the courts should view these scenarios, in terms of its entirety, would be very helpful and could go a long way towards clarifying whether these contracts do fall within the jurisdiction of the CFTC.

The second thing I would mention is the ability of the commission to enforce fraud and manipulation in over-the-counter markets. Again, I think through 2(g) and 2(h), which were very important components of the CFMA—and they were important because creating legal certainty in the over-the-counter markets was a key component of the CFMA, and those two provisions go directly to that. So those two provision—also, I think it is clear that Congress intended the CFTC to have some enforcement authority in these areas. That has been muddled a little bit by the language in 4b, which is the general anti-fraud provisions of the act. I think instead of going into 2(g) and 2(h) and messing with the legal certainty issue of OTC, which none of us want to do, I think if we simply went to 4b and we looked at the intermediated language there, and if the Congress decided to take out that language, that would then clarify that the CFTC does and can use their anti-fraud/enforcement authority.

Mr. BOEHNER. I know my time is expired, but I will leave the Sarbanes-Oxley question to the chairman because I would be interested in the effect at the CME, and now at the Board of Trade, what that means in terms of governance and the challenges that it brings.

Let me just thank all of you for being here, and it has been a pleasure to work with you. I look forward to continuing to work with you as we reauthorize the Commodities Exchange Act.

Mr. MORAN. Thank you, Mr. Boehner. The gentleman from Washington, Mr. Larsen.

Mr. LARSEN. Thank you, Mr. Chairman, and thank the panel for helping us out this morning. And my questions are really for Dr. Newsome. Welcome back before the subcommittee. You mentioned 2(g) and 2(h), and I wanted to explore those a little bit, and then, as well, get some of your thoughts on how, say, fixing or removing 4b would fix the 2(g)/2(h) question.

I understand that 2(h) provides exemptive relief for energy, metal, and chemical contracts, subject to the applicability of the specific provisions of the CEA. There is a memo that was provided in 2001 that talks a little bit about 2(g). As well, it says a section 2(g) exclusion will be particularly relevant to transactions not executed on a trading facility that involves metals, chemicals, or energy products, so I am trying to understand if 2(h) provides exemptive relief for those products, and 2(g), perhaps, at least in one per-

son's opinion, provides exemptive relief for those products, why the necessity for both?

How often would 2(h) be used, or 2(g) be used, if they apply to the same set of contracts. And then, third, you introduced the question of 4b or modifying or removing that would solve some of the questions surrounding the use of 2(h) and 2(g). Is that enough for you? You have 4 minutes.

Mr. NEWSOME. OK. Let me attempt to do it very quickly.

Again, I think when the act was looked at, legal certainty primarily in the over-the-counter markets, was a priority. Energy markets entered that discussion relatively early in the phase.

Quite frankly, the CFTC had great comfort in saying that the financial markets should be excluded; and therefore, the 2(g) exclusion. We had not done the due diligence with the energies and metals markets and therefore did not give a real answer to the Congress with regard to either energy or metals because we had not done that due diligence. We had no reason to believe that they couldn't be included, but again, we didn't have the study to back it up, nor had the president's working group looked at it in detail as they had in the financial markets.

Mr. LARSEN. I am sorry. When you say included, you mean included in 2(g) or—

Mr. NEWSOME. You are getting a bit more technical than I am prepared to comment on this morning. I guess, getting to the root of the problem, which is what I tried to address a few moments ago.

I think, clearly, through 2(g) and 2(h), Congress demonstrated the desire for the CFTC to have some authority in these marketplaces with regard to enforcement. The only reason that is thrown into question is because of the 4b, the general anti-fraud provisions of the act. And 4b specifically talks about for or on behalf of. And the commission's ability to go after those, otherwise—in non-intermediated becomes a question mark because of the general fraud language in 4b, of course in 2(g) and 2(h), you are talking about bilateral.

And so that has raised the question of whether or not the CFTC has the authority that Congress intended, because of the language in 4b. My point is that if the language in 4b is clarified, or if the "for" or "on behalf of" language is taken out, then clearly the commission would have the authority to utilize its enforcement powers in non-intermediated situations.

Mr. LARSEN. So then if 4b was removed, you are saying that the commission would have the authority to use its anti-fraud authority to regulate 2(g) and 2(h) transactions for fraud.

Mr. NEWSOME. That would be my opinion, yes, sir.

Mr. LARSEN. Right.

Mr. NEWSOME. But I would also say that, as this committee knows, it is very easy to come up with unintended consequences, so I think the discussion about that should be inclusive of a number of market participants to make sure that through doing that we don't end up with some unintended, negative consequences.

But I certainly think it is worthy of the discussion of this committee.

Mr. LARSEN. Thank you, Mr. Chairman.

Mr. MORAN. Thank you, Mr. Larsen.

In follow up a bit to what Mr. Newsome said, does anyone believe, in light of the *Zelener* case, that it is time for Congress to define what a futures contract is? And is there some industry effort underway that would help us in that regard or head down this path at all? Mr. Duffy?

Mr. DUFFY. Yes, Mr. Chairman, I think that to define a futures contract and open up the act might be something that no one is prepared to do, but I think that if we look at the original intent of Congress—and there may be a quick fix that we can look at that does not open the act—which is basically to say that a retail foreign exchange trader who uses these contracts for the shifting of risk or speculation should be subject to CFTC regulation. I think it is that simple. I don't think that has to define a futures contract, which then, in turn, would open up the act. So I think that simple language fix could help solve some of this problem that we have today.

Mr. MORAN. Does any of the panel have anything contrary or addition of Mr. Duffy's suggestion?

Mr. DUFFY. Thank you.

Mr. MORAN. Mr. Carey, you talk about the global clearing link and co-mingling of funds. It is my understanding the CFTC approved such co-mingling in similar circumstances in the past. Is that true, and are the benefits of a global clearing link completely outweighed by protection issues?

Mr. CAREY. Well, I believe that the benefits of global competition do not outweigh our responsibility to maintain integrity in the market place. Our No. 1 priority has to be the confidence that Dr. Newsome referred in your marketplace. And the fact that these do raise novel issues—secure funds versus segregated funds and cross-border bankruptcy laws—they raise questions that should be answered. So our position on that is that the priority has to be maintained, the customer protections, and the integrity of the marketplace. And when you are dealing with a cross-border link, it does raise questions, so we would prioritize customer protection in this case.

Mr. NANDAPURKAR. Mr. Chairman?

Mr. MORAN. Yes, sir.

Mr. NANDAPURKAR. I would like to just to step back and talk a little bit about global trading in general and then talk a little bit about global clearing for the committee. Today there are a lot of traders here in the United States that trade European products; there is a lot of traders in Europe that are trading U.S. products. In fact, it is all our strategies to grow the U.S. business by expanding in Europe and Asia. What we are proposing with the global clearing link is a mechanism that basically links our clearinghouse, the Clearing Corporation, with Eurex's clearinghouse, Eurex Clearing, to actually make it more efficient and more cost-effective for people to do that global, cross-border trade.

The first phase of that is already approved, and it allows U.S. traders that are trading overseas on Eurex to actually repatriate their funds back into the United States. So today, before that went into place, they would trade on Eurex in a European regulatory environment and leave their funds over there with a European clear-

ing firm. Now, thanks to the first phase that has been approved, they can trade over in Europe, but they can repatriate their fund and use their existing relationship in the United States and hold their positions in the U.S. and their funds in the United States.

Now, what we are seeking approval for is the second phase, and that is what we are working on, and we hope that that second phase will actually make it a lot more efficient for a lot of small- and medium-sized traders in Europe to start doing business in the United States. And the way that we are hoping to do that is by allowing those traders to trade U.S. products on Eurex U.S., but then hold their positions at their existing clearing relationships in Europe.

And the way we are structuring this link follows and builds on precedence in other clearing links that have placed for over 20 years, such as the CME's clearing link with the SGX, and more recently, the CME's clearing link with MAF. We feel that the structure we are going to be proposing is in line with the precedence that is already out there.

We have been in discussion with the CFTC. We plan to file an application very soon, and the application, we expect, will be put out for comment, and we have committed that we wouldn't move forward with this clearing link until we do get CFTC approval. And I am confident that CFTC will be reviewing this thoroughly; it will go out for public comment; and they will be very comfortable with what we have proposed.

Mr. MORAN. Mr. Nandapurkar, are there issues that we ought to keep in mind as—in consumer protection in this cross-border—these cross-border transactions? Issues related to information enforcement? The bankruptcy laws? What concerns are legitimate?

Mr. NANDAPURKAR. Yes, one of the things that we have done in implementing this is, when it comes to a U.S. customer—especially a U.S. customer trading on a U.S. exchange, we have implemented a structure where they are guaranteed the highest level of protection for their funds, and that was important for us to do in terms of getting this first phase in place. I am sure you have heard terms like segregated funds versus secured funds—and I am not a lawyer nor a regulatory expert, but one of the things I know we had to guarantee—and we wanted to guarantee—was that the U.S. customer got the highest level of protection in getting these funds in place.

And whenever a U.S. customer, or any customer, is trading on Eurex U.S., they are always subject to U.S. regulatory rules and rules of our exchange.

Mr. CAREY. Mr. Chairman? Could I make one more point? One of the things I would like to state to complete my comments earlier—it is a little bit hard to talk about the structure of phase 2 because there has been no application yet. And the CME-SIMEX link, which was referred to, was established before the CFMA, before there was any such thing as a DCO. Now that there is a registration category for this business, every clearinghouse that clears U.S. trades should register. We continue to believe that getting a DCO approval is the best way to structure the link to ensure protection of the customers.

Mr. MORAN. I think one of the things you raise, Mr. Carey, in your testimony, is a concern that we may level-down the level of regulation.

Mr. CAREY. A race to the bottom?

Mr. MORAN. Bring us to the bottom. One of the goals of CFMA was to create a more level playing field with international competitors, and it seems to me that we have had some success. Are there examples of regulatory imbalances internationally that we should be made aware of?

Mr. CAREY. To answer that, there is potential because these exchanges, when you start to link them, have different rules in their domicile countries, and the customer protections do vary, and I think it is important to have that dialogue and to work through these issues. Again, it is about the integrity of the marketplace and the customer protection. So without referencing any specific cases, I would say that the comparisons have to be made to ensure that the playing field is level and that the customers are protected in the same way.

Mr. MORAN. Is there a benefit that accrues to U.S. exchanges because of consumer confidence in our regulatory scheme? Is the reality is that U.S. exchanges get international business because it is less risky?

Mr. CAREY. Clearly. We have a 157-year history of no defaults. We go through rule-enforcement reviews. The commission has strong oversight, and you have oversight over the commissions, so we clearly believe that the integrity in the U.S. markets has contributed to their success.

Mr. MORAN. The story would be that business accrues to the United States' exchanges because of the system we have, and there are international customers who would choose to transact business here because of that?

Mr. CAREY. Absolutely.

Mr. DUFFY. Can I add to that?

Mr. MORAN. Sure, Mr. Duffy.

Mr. DUFFY. I think there are some other points, to add to that. I think it is because of the innovation that the U.S. exchanges and the people behind them have demonstrated that has created product for the world to participate in, also. So I think that cannot be overlooked, and it goes to the point of exchanges who create product for the world to benefit—especially the U.S. citizens—that product should not be able to just be pillaged by any other exchange. So it is the innovation factor, also, that makes U.S. exchanges attractive to international customers.

Mr. NANDAPURKAR. Could I add a follow-up? I think what we have to remember is that the European exchanges—there are some pretty large European exchanges, and in fact, by many measures, Eurex is actually the largest exchange in the world. And about 20 percent of Eurex's business is coming from the United States already, so we have already got a lot of this business going back and forth. And with respect to Mr. Carey's point about the precedent, I believe the last clearing link that was put in place was CME MAF, and that was done after the CFMA, so one of the precedents we are looking at is the precedent of business that is done after the CFMA.

In terms of trying to—regulatory impediments to going into Europe, I am actually aware of none, in terms of—or actually aware of none that would stop the U.S. exchanges from doing what we have done here. The way, traditionally, exchanges have moved global is by putting remote terminals in the other countries, getting an approval. The European exchange gets an approval to put their remote terminals in the United States; a U.S. gets approval to put their remote terminals in other countries in Europe; and then you string lines back and forth across the Atlantic in trying to grow your business.

What we have done here is we have taken much more of a long-term approach. Instead of coming in through the window, we are coming in through the front door. We have set up a proper U.S. exchange that CFTC registered, CFTC regulated, and we are here on the ground, and we are looking to actually move the business off of this remote process, onto our main exchange, the European business, and that takes time to set up, and it takes a lot of investment. And I think the NYMEX is looking to do something like that. NYBOT has set up an NA in Ireland, and I know Mr. Sprecher from ICE, who you are going to hear from later, has bought the IPEE, in trying an exchange on the ground in London in trying to expand.

But we have done something a little different. We have set up for the long run here by making a \$60 million-plus investment and taken a lot of time to get the exchange set up right, as a proper U.S. exchange, here.

Mr. MORAN. I would like to pursue this a little further, but my time is expired.

The gentleman from North Carolina, Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I have a couple questions. If you will bear with me, I am going to ask those and then ask each one of you to cover the areas that I have questioned, and hopefully, that will save my time and yours, too. For you, Mr. Duffy, in your testimony, when talking about securities futures products, you say it is time to let futures exchanges trade the product as pure futures/securities products. "Let the relevant exchanges deal solely with their respective regulator." I want to explore exactly what you are looking for when you make this statement. Should we allow the CFTC and SEC to regulate these products independently and let the market determine whose regulator vision for these products are better, or should we maintain the CFTC and the ESEC's collaboration on crafting regulation for these products, but allow the exchanges to deal solely with their respective regulators. Or perhaps, you would prefer a single agency to have full regulatory authority over these securities futures—or is that what you are talking about?

Mr. DUFFY. Well, thank you, sir. What I am referring to—and I think you did outline most of my testimony on single-stock futures—we do believe that the CFTC should be able to regulate the futures—single-stock futures part of it. And if the securities exchanges want to trade single issues, they should go ahead and be regulated by SEC. These contracts were doomed to fail from the beginning from margin and every other impediment that goes along with it. The cost of regulation is very expensive. When you have

dual-regulation costs, it is a big, large deterrent for participants to trade in these markets, so I think that you outlined exactly what we are asking for, which is to have the CFTC regulate single-stock futures that are traded on our exchange. And if a securities exchange wants to trade that product, let the regulator regulate them, and we believe that will end the dual-regulation problem.

Mr. ETHERIDGE. OK. Anyone else have a comment?

Mr. NANDAPURKAR. Yes, sir. I would like to comment, Congressman. Having sat at a chair, negotiating with the SEC while we were implementing the act, I think I have some insight into that that no one else may have. I would say that I agree entirely with Mr. Duffy's evaluation and comments on how to move this forward. Allowing the trading of single-stock futures was another large component of the act and a very big component. The Congress chose to ask the CFTC and the SEC to cooperate from a regulatory standpoint, moving forward. I will tell you that was tried; it was tried diligently. I believe everyone was at the table in a good-faith effort, but at the end of the day, it has failed.

There is a fundamental difference for why it has failed, and I think it goes to the differences in the marketplaces. You have got the securities business; it is about capital formation. The futures business, that is about risk management. And because of that fundamental difference, the SEC has developed a regulatory scheme based up on customer protection; the futures industry had developed a regulatory scheme based upon market integrity. And when you try to meld those two together to regulate a single product, it just has not worked.

So to me a logical solution is to allow both of the industries to trade their own products on securities exchanges, on futures exchanges, regulated by the SEC and the CFTC and to allow the marketplace to choose where they would like to do that business.

Mr. MORAN. Thank you.

Mr. ETHERIDGE. All right and this may give you a chance to comment, too, Mr. Nandapurkar. You have heard the concerns raised about the second phase of your global trading link. Does the Eurex German clearing-plan plan to register as a designated clearing organization, or do you believe that registration is not necessary or required? And why would Eurex not want to register? And Mr. Newsome, you have commented already, but you were CFTC Commissioner, the quote regarding Eurex having to register as a designated clearinghouse was attributed to you. Do you still believe that?

Mr. NANDAPURKAR. The way we are structuring this link, the way we set this link up, we believe follows and builds on precedence that have been in place with other clearing links for the last 20 years. Some of those clearing links were before the CFMA. There is one that we picked up that was after the CFMA. But regardless—and again, I am not a lawyer or a regulatory expert, but from what my lawyers tell me, the precedence still applies.

So our view, basically, is that there is precedence out there where there have been clearing links in place. We are following that precedence; we are building on it; and in none of those cases was registration required. Now, I have a great deal of respect for Dr. Newsome, and we would agree that with certain clearing-link

structures that registration as DCO could be appropriate. However, we think our structure follows and builds on the precedence and has a particular structure where it may not be appropriate. And in those other cases, it was not appropriate. But again, we are going to bring our application forward very soon. It will be put out for public comment, and we have committed not to move forward until the CFTC does approve it.

Mr. NEWSOME. Mr. Etheridge, I would make just a couple of comments. As I testified to this committee, I believe that the CFTC should maintain that flexibility to make the determination of whether DCO status is required.

I am not familiar with the application and certainly haven't been in contact with them, but I am very confident in the CFTC's ability to have that flexibility based upon the Eurex U.S. application to make the appropriate judgment.

If that direction is not chosen, and say the CFTC decides that there is no need for DCO registration or status, it is very difficult looking at these kind of projects from the regulatory standpoint because at the end of the day, based upon the types of issues that Chairman Moran mentioned, specifically bankruptcy, there is never going to be a peg in every hole. It is just very difficult to make that happen. So I think you have to rely upon disclosure. Disclosure is something commonly used in the financial industry, and if at the end of the day you can't get a peg in every hole, I think you have to disclose the differences to consumers about the regulatory functions in Europe, the regulatory functions in the United States, and what that means to those customers.

Mr. ETHERIDGE. Thank you. Thank you, Mr. Chairman. I see my time has expired.

Mr. MORAN. Thank you, Mr. Etheridge. To the panelist who continues to disclaim being a lawyer, please recognize the chairman is one. I am assuming you are saying it in a way that suggests that you would have more knowledge if you were.

Mr. NEWSOME. Lovingly, very lovingly.

Mr. MORAN. The gentleman from Louisiana, Mr. Melancon, welcome to the subcommittee. Any questions of our witnesses?

Mr. MELANCON. No, I don't.

Mr. MORAN. Thank you very much.

The gentleman from Iowa, Mr. Boswell.

Mr. BOSWELL. Thank you, Mr. Chairman, and we don't hold it against you that you are a lawyer.

Mr. MORAN. The surprising thing is that I admitted it.

Mr. BOSWELL. Oh, I am not touching that. It is a good profession. I am going to read what has taken place. I won't take up your time, but I appreciate my Chicago friends here and the rest of you as well, but I know that you have made an effort to be here and be a part of this, and thank you for it, and I will just have to talk to you later. I was next door at the WTO meeting, so I just haven't figured out—they say I am big enough to be in two places if you could split me, but I just haven't figured it out yet. Thank you.

Mr. MORAN. Thank you, Mr. Boswell. Now, Mr. Boehner talked about Sarbanes-Oxley, and both the Chicago Mercantile and the Board of Trade are or are becoming publicly traded entities. I didn't say that correct. Publicly—a non—a for-profit organization.

Mr. DUFFY. We already are.

Mr. MORAN. Tell me what regulatory environments Sarbanes-Oxley adds to your circumstances?

Mr. DUFFY. First, the Chicago Mercantile Exchange has been a public company since 2000, and it became a listed company in 2002. The Chicago Mercantile Exchange complies with all Sarbanes-Oxley requirements; it complies with all NYSE requirements and all SEC-listed company requirements.

I think there is some confusion by the definition of independence versus what is a conflict of interest. If there is a potential conflict of interest by one of our board members, they have to abstain. So right now, we understand all of the requirements of Sarbanes-Oxley, and one of the things that we have, unique to anybody else sitting up on this panel, being a listed company, we have shareholders, and they vote with their feet, obviously, and they vote with their pocketbooks, and that is how they put their boards together.

When myself and others in this room took the Chicago Mercantile Exchange public, it was roughly a \$600 to \$700 million cap company. Today we are roughly \$7 billion market cap company. I think our shareholders see the benefits of our board of directors and what Sarbanes-Oxley has been able to provide for the CME. The CME, also, is one of the most transparent listed companies on the New York Stock Exchange. 80 percent of our revenue is derived from transactions, so you can see on a daily basis exactly where we are at.

So when it comes to a Sarbanes-Oxley, we have obviously complied with every requirement of every other listed company.

Mr. MORAN. Mr. Carey, anything to add?

Mr. CAREY. Well, I would like just to say that we are transitioning to a for-profit company, and someday, we may be a publicly traded company. I would like to compliment Chairman Duffy on their success with the Chicago Mercantile Exchange. He got into a little bit of the independent director definition, and I would say that there is nothing to suggest that exchange members that serve on our board are not independent. We disagree, strongly, with the FIA on this point.

Both exchanges and the CFTC have recognized that having knowledgeable and expert members on the board of directors has served us well. In fact, SROs were granted flexibility in fulfilling their obligations under the CFMA. The CFMA, itself, notes that DCMs shall have reasonable discretion in establishing the manner in which they comply with the core principals.

The CFTC conducts periodic reviews, rule-enforcement reviews, so again, I think that a member's interest, as far as the integrity of the exchange and the decision-making process are in complete alignment. And if we were a publicly traded company, we would have to comply with Sarbanes-Oxley, also.

Mr. MORAN. Since the passage of CFMA, are there examples where self-regulation has failed?

Mr. CAREY. Well, I am not aware of any. There may be, but I am not aware.

Mr. MORAN. Mr. Newsome, this might be an appropriate question for you.

Mr. NEWSOME. Mr. Chairman, I am not aware of any, certainly no major issues where the SRO function has failed during my tenure at the CFTC. I can't recall that being the case. Certainly, there are ongoing discussions between the CFTC and the SROs with regard to that responsibility and what that responsibility entails. The CFTC consistently gives guidance to the exchanges with their thoughts on how to maintain the strong SRO function.

In general, I was at the CFTC when we started the SRO review. And I would remind the committee that we started that review before anything happened in the securities industry, so we were actually being proactive and simply not reacting to any kind of tragedies or major events within our business. I simply thought it was prudent for the agency to review the responsibilities of the self-regulated organizations. I think everyone would agree that, in general, that setup work very well, has worked very well over time, and I think we are all anxious for the CFTC to issue their findings and thoughts.

Mr. MORAN. Mr. Newsome, thank you. I call to the committee's attention NYMEX's testimony and the summary and the comment about the hedge fund participation. I think this energy sector will be a topic of conversation in this committee, and perhaps even more so in the Senate, and I think there are some findings that I think are interesting in regard to that topic, and I appreciate that information being available.

And then, finally, can any of you use your crystal ball and tell me what you see happening in the futures industry into the future? My guess is that many things that have transpired since the passage of CFMA, you may not have thought about when we were discussing CFMA 4 or 5 years ago. What kinds of things should be concerned about? What should we foresee as we look to regulation for the next 4 or 5 years?

Mr. DUFFY. I will be happy to start, if it is OK, Mr. Chairman. Obviously, as far as projections, we are very careful, as a publicly traded company, not to give any forward-looking projections, but on regulation, I will just say that if you look at some of the problems that we see—you know, again it is tied to my testimony with foreign exchange, and it may be spilling over to other difference products, such as heating oil and orange juice, which Chairman Brown-Hruska has testified to—so I think that the unregulated, retail customer is something that can be continually preyed on as this business continues to grow, which it is showing every evidence that it is going to do so. The unsuspecting retail customer that thinks he is trading on a regulated marketplace may be deceived, if we don't close a few of these loopholes, that problems could continue to get bigger.

There was an investigation led by Dr. Newsome when he was Chairman of the CFTC, called Wooden Nickel, which I believe is one of the largest forex stings in the history of the agency, and they did a wonderful job. I think we could be looking on more of an annual basis that an historic-type basis if loopholes are not closed. So on the regulatory side, I would urge Congress to look very closely at protecting its retail clients.

Mr. NANDAPURKAR. If I could? I think there are three basic trends that are driving growth in the futures industry. One is the

move toward electronic trading. And I think, from a regulatory perspective, there you are talking about distributing the potential to real-time in these markets, throughout the country. So you have got both the CFTC involved—but there may be issues in terms of State and local governments that may get involved in terms of enforcing some of the regulations and how sales practices are done from those distributed offices everywhere. Now, the electronic trading makes that a lot easier.

I think the second is just the trend towards globalization and the fact that you are going to have more and more people around the world trading each others' products. Whether it is Asians trading in the United States, whether it is people in the United States trading in Europe, there is just going to be a trend towards more globalization. I think the regulatory issue there is really about regulators cooperating, and think the CFTC is doing a very good job there. But regulators cooperating around the world and realizing that markets are interlinked, whether it is European interest-rate markets and U.S. interest-rate markets, and how they move.

And then the third is we are probably at the early stages of a secular trend, where business is moving from the OTC market back into the listed market, and I think the CFMA has a lot to do with that. I think we are starting to see where people do want a multi-lateral clearinghouse to be in the middle of the transaction. It is a much greater capital efficiency to have a clearinghouse in the middle of transactions, and people want the transparency of a mark-to-marketed trade every day. So you know what the position is. So I think we are in the middle of that trend, and I think we need to be open to bridges from the OTC market into the listed market so that trades, as they get done, OTC can be cleared more in the listed market in a regulated clearinghouse.

Mr. NEWSOME. Mr. Chairman, just a couple of quick comments.

I think the globalization issue is one that certainly is going to be on the forefront. I think the CFTC is taking appropriate steps with regard to memorandums of understandings with foreign jurisdictions and information-sharing agreements; but I think the difference between different jurisdictions possibly limiting the ability to do business globally is an issue that the committee may have to consider over the next several years.

Second, as chairman of the CFTC, while I was very supportive of the flexible nature of the act and allowing businesses to actually conduct business and grow, at the same time, I was a very strict believer in the strong enforcement authority of the CFTC, and very used that authority very aggressively when I was chairman. I think it is extremely important that the authority of the CFTC with regard to enforcement be very clear. And that goes to the comments I made earlier to Mr. Larsen. So I think that is an issue that certainly can be addressed.

And then the other, which is a more difficult issue: I think as we continued to have a growing world economy, more and more pressure will be put on commodities, particularly energy. We have to come to the understanding that these markets are going to volatile. That volatility is not created at the exchange. The volatility is in the underlying cash market, and it becomes transparent at the exchange because the exchanges are the only place for that trans-

parency to take place. It doesn't happen in the underlying cash market; it doesn't happen in the OTC market.

I would just ask the committee to be careful not to shoot the messenger of that price volatility because I expect it to continue. Certainly, it is going to be a question, and issues are going to be raised. But I look forward to working with this committee to address any issues that are raised, as well.

Mr. CAREY. I would like to add that I am in agreement with the CEO of Eurex U.S. We have witnessed a recapturing of over-the-counter business that has now come to the regulated environment, the exchange-traded environment, and between that and electronic trading, we have seen tremendous growth in our products—as I said 600 million contracts last year.

I think the challenge to the committee and the commission is going to be the fact that these markets are all interlinked and interrelated—over-the counter, foreign markets, and with electronic trading they move swiftly, so it is going to be a challenge to regulate in that environment, also, but I think that were are looking at a strong growth proposition.

Mr. DUFFY. Mr. Chairman, if I might add one final comment on that.

I think that if you look back on Eurex's testimony, when one talks about the application of Eurex U.S. and regulatory arbitrageurs that may come upon us, I think that we should not get lulled to sleep believig that the potential for regulatory arbitrageurs cannot still happen. And I think when we look back at, maybe, some of the potential wrongdoing or the lack of discipline on some of the foreign markets, when there were definitely some potential squeezes going on in their products, the regulator didn't act. So I think you have to look at potential regulatory arbitrage; though I don't want to suggest either that inter-governmental memorandums of understandings are not useful or that the world is such a beautiful place that we don't need effective international regulation.

Mr. MORAN. I would welcome the panel and ask staff to provide me with examples of where the regulators failed in foreign markets. I would be interested in seeing what those examples of that would be. Anyone else?

Mr. SCHOENHUT. Thank you, Mr. Chairman. I would like to add one, last thing. While I agree with much of what has been said, with respect to this, I think there needs to be a great sensitivity given to the financial climate that we are currently in.

In the advent of the stock market fall-out of 2000, commodity equity index and dead instruments have created a need for highly sophisticated investors and hedge participants in our markets. Other similar users also recognize commodities in today's world as a separate and distinct investment class. I think that is given rise to a great deal of the volume increases that we have all been able to share.

So I think that these factors and the investment-heading community, being given a new ability to mitigate risk, certainly opens up the door for the CFTC and their reauthorization and people to have the confidence to trade our markets, certainly, would be the theme of the day.

Mr. NANDAPURKAR. If I could make one, last comment, just on the theme that I think is very important in this low-interest-rate environment/low-return-environment, how much money is flowing into hedge funds? And specifically, how much hedge funds are starting to move into the listed world?

And when you combine the listed exchanges, the trend toward electronic trading, that execution can take place so quickly, and you have got these super-smart hedge funds out there hiring Ph.D.'s in computer science and physics that are writing the models, now you are going to have exchanges around the world linked anyway, and hedge funds figuring out with their models how to maximize their capital usage, but pick up arbitrages. Those differences in markets and where people think real statistics arbitrages, economic arbitrages—those things are going to go away very quickly. And the hedge funds are moving their money, and the biggest trend here is they are starting to move much more into the listed world and onto the exchanges—define their edges to please their customers. And I think you are going to see a lot faster movements in closing of the gap between markets globally.

Mr. MORAN. The chair recognizes the gentleman from Washington for a final question.

Mr. LARSEN. Thank you, Mr. Chairman.

Dr. Newsome, just 5 more minutes; that is all. You mentioned transparency—don't shoot the messenger that the market provides a transparency—and I fully agree. The crux of my questions are, then, does the CEA, then, provide proper authorization to the CFTC that once that transparency shows there is a problem, then is there an authority there to protect the players in the market from fraud, from manipulation, and so on? And along those lines, last week, Acting Chairman Brown-Hruska made it sound as though—and this gets back to 2(h) and 2(g)—made it sound as though 2(h) applies to 2(g) transactions as well. Is that how you and your members understand the current statute, that there is no great difference between the two?

Mr. NEWSOME. Well, I think when I was chairman, there was a big discussion, and it happened to be in a Senate hearing with regard to whether or not the exclusion trumps the exemption.

I didn't believe that to be the case, and I would just say that from a practical standpoint, in the CFTC we were very aggressive in bringing that enforcement action within the energy sector, and we were not challenged on it. Now, we could be challenged at some point, and my opinion could be found to be not true; but I think with all of the legal-certainty issues, I would be hesitant to go in and make changes to 2(h) and 2(g) when I think the enforcement authority can be addressed through the 4b, through the general fraud authority of the CFTC.

Mr. LARSEN. Mr. Chairman, with your consent—I have been citing the contents of a memo that may or may not be in the record; I just want to ensure that it is in the record.

Mr. MORAN. Without objection, so ordered.

[The material appears at the conclusion of the hearing.]

Mr. LARSEN. That way, folks can know what I am reading from, as well. I think that currently answers my questions. I am still kind of exploring this, and I am sure we all be available as we con-

tinue through this to—so I can come up with additional questions, and I may have additional questions for the next panel, as well, on this subject.

Mr. NEWSOME. I look forward to meeting with you anytime, Congressman.

Mr. LARSEN. Thank you.

Mr. MORAN. I thank the panel very much for their—taking the time to educate our subcommittee, and I will dismiss this panel and now call upon panel 2.

Mr. MORAN. Thank you. John Damgard, president of the Futures Industry Association; Mr. Daniel J. Roth, president and chief executive officer of the National Futures Association; Mr. Micah S. Green, president of the Bond Association; John Gaine, president of the Managed Funds Association; and Mr. Robert Pickel, executive director and chief executive officer, International Swaps and Derivatives.

[Recess.]

Mr. MORAN. The committee will resume and come to order. Mr. Damgard, you may begin when you are ready.

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

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

Chairman Moran, Ranking Member Etheridge, and other members of the subcommittee, on behalf of the Futures Industry Association, I want to thank you for the opportunity to appear here today.

I have an advantage over the others at the table in that I have been involved in every CFTC reauthorization since the agency was created in 1974—if that is an advantage. I think it just means that I am old. I know, firsthand, the historic and vital role that the House Agriculture Committee has played in periodically reviewing the CFTC's operations and reforming the Commodity Exchange Act, when warranted. This subcommittee's work on the Commodities Futures Modernization Act of 2000 is only the latest example of your significant contribution to our mutual goals of strong, competitive, innovative, and honest futures and options market. Your longstanding commitment is greatly appreciated by this futures industry, and I am very sincere when I say that a lot of the success that we are enjoying right now is a direct result of the hard work of this committee, and I might add, some of the staff members like John Riley and David Ebersole and Tyler Wegmeyer have been extremely helpful in working to prepare for this hearing, and we appreciate that as well.

In light of that expertise, we would make a specific recommendation to the subcommittee. And that is, as you may know, the Senate's version of last year's energy bill contained amendments to the Commodity Exchange Act. In light of your expertise, we were pleased last week when the subcommittee indicated it would discuss with members of the Energy and Commerce Committee, efforts to amend the CEA in that committee. We believe that any changes to the CEA this year should become part of the House Agriculture Committee's consideration of CFTC reauthorization.

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

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

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

That is why we have concerns about any proposal to expand the CFTC's jurisdiction as a response to the ongoing problems of fraud against retail customers in the OTC/FX transactions. The CFTC was not set up to become a national consumer protection agency for commodity transactions, a fact this committee recognized in 1982, when it endorsed the CFTC's recommendation to amend the act to include an open-season provision, which explicitly authorized the application of any Federal or State law to persons that engaged in unlawful commodity transactions. As the committee wrote, "the States should be extensively involved in actions against those who offer fraudulent off-exchange investments and in policing transactions outside those preserved exclusively for the jurisdiction of the CFTC."

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

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

No one wants to go back to the days when all exchange rule changes required costly and time-consuming CFTC approval. Our

concern is if the current regime works to shut out our members and their customers from both the exchange internal rule approval process and any subsequent CFTC review. For example, a 3-day private comment period is no substitute for the kind of due process anyone would expect from fully-informed deliberation over an important exchange rule. We look forward to working with this subcommittee, the commission, and the exchanges to make exchange rulemakings more open to public comment and input.

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

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

In conclusion, Mr. Chairman, FIA looks forward to working with the subcommittee and its staff. We believe that with handful of changes, we can make an excellent regulatory system even better. Thank you very much.

[The prepared statement of Mr. Damgard appears at the conclusion of the hearing.]

Mr. MORAN. Thank you, Mr. Damgard. Mr. Roth.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. ROTH. Thank you, Mr. Chairman. My name is Dan Roth, and I am the president of National Futures Association. NFA is the industry-wide self-regulatory body for the futures industry. And the process of self-regulation has received a fair amount of criticism over the last couple of years, and I think the problems in the securities industry and the self-regulatory process in the securities industry have been well publicized.

What hasn't been so well publicized is the success of self-regulation in the futures industry. Since 1982, when NFA began operations, futures volume on U.S. exchanges has gone up by over 1,200 percent. During that same time, customer complaints have actually dropped by 75 percent. That is a fairly dramatic achievement, and it hasn't been an accident.

That reduction in customer complaints has been the result of a lot of hard work and a very close-working partnership between the CFTC and NFA to shut down those boiler rooms and those bucket shops that generated so many of those complaints.

As we sit here, today, though, that trend, that achievement in reducing those numbers of complaints—I think that trend is in some jeopardy. And it is in some jeopardy because the CFMA, for all of its success, failed to achieve one of its customer-protection objectives. The CFMA tried to clarify once and for all the CFTC’s authority to protect retail customers investing in foreign-currency futures. As we sit here today, I think the CFTC’s authority to protect retail customers may be more uncertain now than it was then. And the main problem, that you have all heard about and that everybody has talked about, is the *Zelener* decision.

That *Zelener* decision, in my view, basically did three things. No. 1, it made it much harder for the commission to prove that these leveraged contracts sold to retail customers to speculate in commodities prices are, in fact, futures. No. 2, it made it much easier for the boiler rooms to therefore set up their operations in a way that they can remove themselves from CFTC regulation. And No. 3, it created an honest-to-God, real-life customer-protection issue. And to make matters just a little bit worse, that customer-protection issue is not limited to foreign-currency products. The boiler rooms that want to use the *Zelener* decision to self-warrant currency products could do the same thing for heating oil, unleaded gas, agricultural products, metals—just about any commodity that you can mention.

At NFA, we feel that the *Zelener* decision represents a real threat to customers and a threat that Congress has to meet head-on. I have heard four different reasons why maybe Congress shouldn’t be aggressive in this area and shouldn’t act; and I don’t find any of them particularly persuasive.

Number 1 is the notion that there is no reason to clarify the CFTC’s authority to protect retail customers because the States have that authority. Well, Mr. Chairman, I have spend over 20 years working with State regulators, and I can tell you firsthand that they are dedicated; they are committed; they are intelligent; and they are overwhelmed. Anybody that thinks that the States have the resources and the expertise to protect retail customers from futures-look-alike scams is just dreaming.

Number 2, there is a thought that maybe the CFTC can just litigate itself out of the *Zelener* decision by bringing different types of enforcement cases in the future. And for all of the reasons I laid out in my written testimony, I want you to know that I think that proposition is a lot harder than it sounds. And to rely on future litigation, in my view, places an awful lot of chips on a bet that is no sure thing.

Number 3, some people have felt that it is premature at this point for Congress to Act because the *Zelener* decision, itself, was just issued last August and that we should just let events unfurl. But realistically, Mr. Chairman, it seems to me that waiting means waiting until the next reauthorization, and that is 5 years away. And an awful lot of people can get hurt in 5 years, and I don’t think any of us finds that acceptable.

And No. 4, there is notion that whatever legislative solution Congress comes up with here, we should limit its application to foreign-currency products. Well, Mr. Chairman, as I have just described, the problem is not limited to foreign-currency products, and I don’t

think the solution can be either. Now, that is not to say that there aren't some real, legitimate concerns about legislative action here. There are, and I recognize them.

Certainly our goal here would be not to expand the CFTC's jurisdiction, but to restore it. And our goal would be to protect retail customers without having the types of unintended consequences which can actually impair institutional business. That is not what we are trying to do. And I know the problem is hard; I know it is complicated; but just because it is hard doesn't mean it can't get done. There is an awful lot of smart people at the commission; there is a lot of smart people in the industry; and NFA is very committed to working with the commission, with the industry, with this committee, and with just about anybody else on God's green earth that can help us find the right solution that will avoid the types of problems that I have talked about earlier, but which will ensure that the goal that we all share—that customer protection is achieved.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Roth appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much. Mr. Green.

**STATEMENT OF MICAH S. GREEN, PRESIDENT, THE BOND
MARKET ASSOCIATION, NEW YORK, NY**

Mr. GREEN. Good morning, Mr. Chairman, thank you very much. I thank Ranking Member Etheridge and other members of the subcommittee for asking me to be here today. My name is Micah Green; I am president of the Bond Market Association. I thank you for the opportunity to be here to present our views on the reauthorization of the CFMA, which is a law that we think was an outstanding achievement of the Congress.

Through our offices in New York, Washington, and London, the association represents the \$44 trillion global bond markets. Our members include all major dealers in Federal agency bonds as well as securitized products, corporate and municipal securities, in addition to all of the primary dealers of U.S. Government securities as recognized by the Federal Reserve Bank of New York. Our members are also active in markets for over-the-counter financial contracts involving fuller payments and deliveries related to a variety of fixed-income securities, interest-rate, and credit products.

The Bond Market Association participated actively in the debate that led to the enactment of the Commodities Futures Modernization Act of 2000. At that time, we advocated changes in the CEA that we view as critical to vibrant in OTC security, derivatives, and foreign exchange. The CFMA has proved to be extremely successful in that regard because it clarified the exclusion from the Commodities Exchange Act and the jurisdiction of the CFTC of OTC derivatives swaps and foreign-exchange transactions, a much needed certainty that the Treasury amendment and the CEA continues to bring these important sectors of the capital markets, enables efficient markets for U.S. treasury securities in particular, which allows the Federal Government to borrow at a lower cost and saves U.S. taxpayer money.

I want to congratulate this subcommittee and this full committee and your counterparts on the Senate side as well as the past and current leadership and members of the CFTC for your foresight in enacting the CFMA nearly 5 years ago. You clearly anticipated the expansion of the markets around the globe and the need to facilitate liquid and efficient markets wherever they may exist, and to particularly ensure that U.S. markets were not at a disadvantage. You clearly sensed that prescriptive rules and regulation in an economy that requires nimbleness and flexibility would make it more difficult for markets to adjust to changing conditions and that sound, principals-based rules ensure that the markets function smoothly, even in times of stress. Finally, you clearly foresaw the development of sophisticated risk-management techniques that permit institutional market participants to manage risk in an increasingly precise manner. Market participants can retain the risk they wish to retain, and for a fee, transfer those risks they do not wish to retain to another market participant. These improvements in risk management, facilitated by the OTC derivatives markets and the CFMA, have helped the United States and global economies to weather recessions and interest-rate volatility. In other words, the leadership you provided nearly 5 years ago was really quite extraordinary and has provided tangible benefits to the economy.

The Bond Market Association set up three fundamental policy goals during the last reauthorization process that led to the CFMA. We called for maintaining the OTC markets as a viable alternative to traditional organized exchanges, preserving the enforceability of contracts freely negotiated between market participants, and avoiding duplicative regulation. I am happy to report that for the benefit of the broader national and global economy, the CFMA did, in fact, meet these goals.

Clarifying the exclusions of commodities and swaps in the CFTC's jurisdictions and assuring contract enforceability, as the CFMA does, have brought the OTC derivatives market the legal certainty it needed to thrive.

In closing, Mr. Chairman, I would like to reiterate our support for the CFMA. The law strikes a delicate balance between regulating a rapidly changing market and encouraging innovation and diversity. Prior to the CFMA, the OTC markets were restrained by legal uncertainty. Again, thanks to the foresight of the Congress and this committee in particular, the market is now thriving and helping to save taxpayers monies by lowering the cost of borrowing for the Federal Government. Improved risk management and lower capital costs helped stimulate a broader economy.

In the context of the reauthorization process, the Association strongly urges this subcommittee and the Congress not to alter any of the fundamental elements of the CFMA that encourage an orderly and innovated OTC derivatives market. Thank you very much, again, and I look forward to answering any questions that you have.

[The prepared statement of Mr. Green appears at the conclusion of the hearing.]

Mr. MORAN. Thank you, Mr. Green. Mr. Gaine.

**STATEMENT OF JOHN G. GAINES, PRESIDENT, MANAGED
FUNDS ASSOCIATION, WASHINGTON, DC**

Mr. GAINES. Thank you, Mr. Chairman, and members of the subcommittee. My name is Jack Gaines; I am president of the Managed Funds Association, and we certainly appreciate the opportunity to appear here today.

Before I get into my oral comments, which will be relatively brief, I have a written statement which I would like to have included in the record, where we outline in more detail a number of the issues that concern us. But I would like to point out, Mr. Chairman, that this is truly a historic day, not just because of the work of this subcommittee and the CFMA and implementation by Jim Newsome and Sharon Brown-Hruska and the amazing growth of the industry, but I participated in the first reauthorization in 1978, as did John Damgard and Leo Malamed—and if you told me in 1978 that they would outlast Dan Rather, I would be shocked. Particularly John, who doesn't remember that it was here.

Anyway, if I can turn to the more serious side of this. Thank you. This is a great time, obviously, for the hearing. We come before you with no statutory changes to be recommended, but I will footnote that in light of my friend Dan Roth's statement about a gap in fraud.

No one has more interest in the preservation of the integrity of these markets than Managed Funds Association, which is the primary trade association representing professionals in the alternative investment-management business, including hedge funds, funds of funds, and managed futures funds. We are, as I told my children years ago in front of Chairman English—we are pro-anti-fraud, and if there is a gap, we would certainly want to work with the—anybody on God's green earth or wherever else and get it fixed.

We are major customers of the futures exchanges, FCMs. Many of our members are registered as CPOs and CTAs. Our involvement with the Commodity Exchange Act, with the NFA and the CFTC is pervasive.

Increased interest in and use of alternative investments is a direct result of the growing demand from institutional and other sophisticated investors for investment vehicles that deliver true diversification and help them meet their future-funding obligations and other investment objectives. Our members' funds perform a number of important roles in the global marketplace, including contributing to a decrease in overall market volatility, acting as shock absorbers and liquidity providers by standing ready to take positions in volatile markets when other investors choose to remain on the sidelines.

With respect to volatility, I commend to your interest, if you have not seen it yet—is the very thorough study that Jim Newsome and NYMEX prepared on the role of hedge funds in the natural gas and crude oil futures contracts as traded on NYMEX. It is full of data and numbers and not-so-full of opinion and speculation. I think you will find it very useful in your deliberations.

I echo much of what has been said about the importance of the CFMA, the genius that lay behind it, and the way it has been implemented. It has worked very well.

Let me talk briefly about two or three subjects. Hedge funds effects on energy markets, I commend to you again the NYMEX study, and our position is that hedge funds decrease volatility. We do not increase it by our participation in the market. There are a couple of other issues I briefly want to touch on. The clear congressional intent underlying the CFMA was to either de-regulate, go to core principals, or at worst, avoid duplicative regulation. And in doing such, the CFMA amended both the Investment Advisers Act and the Commodity Exchange Act, providing a carve-out so there would not be duplicative regulation of investment advisers at the SEC and commodity trading advisors at the CFTC. We encourage this committee, in its oversight role, to urge those agencies to get on with it, give some definition to what primarily engaged means—this is more fully set forth in the testimony—so that counsel and industry participants can effectively use the exemptions that were clearly designed by Congress.

Speculative limits: there are several petitions pending before the CFTC to relax or liberalize the speculative position limits on certain commodities. We, again, urge the CFTC to take a look at this—I know their plate is full—and we urge this subcommittee, in its oversight role, to keep track of that. It is extremely important to promoting the liquidity and the functioning and price discovery of the markets.

We also urge the committee in its oversight role to encourage the SEC and the CFTC to harmonize their regulatory structures. There is wasted cost. We are the end user—we are sort of in a different part of the food chain than most everyone else here, who either provide you a service or sell a service or provide a market. We are users, and the costs get passed on. And if the costs are not necessary, they ought to be removed. It hurts us in a competitive situation, vis-a-vis, our competition here in the United States as well as globally.

On that note, Mr. Chairman, my time has expired, and I apologize to Mr. Damgard and Mr. Malomed.

[The prepared statement of Mr. Gaine appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Gaine, thank you very much for your commentary as well as your testimony. Mr. Pickel.

**STATEMENT OF ROBERT G. PICKEL, EXECUTIVE DIRECTOR
AND CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS
AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY**

Mr. PICKEL. Mr. Chairman and members of the subcommittee, I appreciate your invitation to testify here today on behalf of ISDA. We have appeared frequently before the subcommittee in prior years, and we welcome the opportunity to be with you today as you continue your important hearings with respect to legislation to reauthorize the Commodity Futures Trading Commission.

ISDA is an international organization, and its more than 600 members include the world's leading dealers in swaps and other off-exchange derivatives transactions, commonly referred to as OTC derivative. ISDA's membership also includes many of the businesses, financial institutions, governmental entities, and other end

users that rely on OTC derivatives to manage risks inherent in their core economic activities affectively and efficiently.

The CFTC administers the CEA, which was revised comprehensively in 2002 by the Commodity Futures Modernization Act. That legislation was adopted, as you know, by Congress with broad bipartisan support after careful consideration over several years by four congressional committees and with the support of the President's working group. The CFMA extended much needed regulatory relief for the futures exchanges, provided legal certainty and regulatory clarity for OTC derivatives and removed the ban on the trading of single-stock futures. It is this principal interest in CFMA that was and remains with those provisions intended to provide legal certainty for OTC derivatives. The phrase legal certainty means simply that the parties to an OTC derivative transaction must be certain that their contracts will be enforceable in accordance with their terms.

The CFMA framework for providing legal certainty is based on a longstanding consensus among Congress, the CFTC, and other that OTC derivatives transactions are not appropriated regulated as futures under the CEA. The legal certainty provisions of the CFMA were intended by Congress to reduce systemic risk and promote financial innovation. Our experience since 2000 confirms that both of these objectives have been achieved. The use of OTC derivatives for risk management purposes has continued to grow, both in periods of economic downturn and uncertainty and in times of economic expansion.

The reductions in systemic risk resulting from enactment of the legal certainty provisions have not come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since the enactment of the CFMA. For example, the significant growth in credit default swaps to manage risk in times of volatility and uncertainty has been greatly enhanced by the legal certainty provision of the CFMA. Similarly, the legal certainty provisions have encouraged dealers to develop and businesses to use an increasing range of new kinds of OTC derivatives, such as weather derivatives, to manage additional types of risk.

Finally, the CFMA removed the regulatory barriers to clearing of OTC derivatives, and while collateralized transactions remain more prevalent, the emergence of alternative clearing proposals attest to the positive effects of the CFMA on financial innovation.

For these reasons, we share the views expressed by Acting Chairman Sharon Brown-Hruska last week before this committee that the CFMA functions extremely well. In our view, this is attributable to the care with which Congress constructed the legislation to the even-handed manner in which the CFTC has interpreted and administered the CFMA in accordance with congressional intent, and to the CFTC's vigorous enforcement program following the collapse of Enron and the California energy situation.

ISDA believes that the experience that its members and other have had under the CFMA demonstrates that there is no fundamental need for Congress to make substantive changes to those portions of legislation governing OTC derivatives. We are aware that others have advocated substantive changes to the legislation,

including changes with respect to OTC derivatives. In our view, however, the case for such changes simply has not been made.

We understand that you and your colleagues will want to have the benefit of a full range of views concerning the CFMA. We think this is highly desirable and welcome the opportunity to participate constructively in the debate and discussion of possible changes. We do, however, urge you and your colleagues to proceed cautiously in reopening the CFMA. The legislation, although carefully crafted, is complex, and the potential for unintended and undesirable consequences from selective changes is great. We also urge you and your colleagues to ensure that your subcommittee asserts fully its right and responsibility to review and approve any substantive changes to the CEA. Our experience in recent years has confirmed that the use of freestanding amendments offered to separate legislation without your committee's review, scrutiny, and public comment is an undesirable method of considering changes to a legislation as complex and as important as the CEA.

Let me conclude, Mr. Chairman, with three observations. First, by providing legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the longstanding policies of Congress and the CFTC, the CFMA materially reduces systemic risk and encourages financial innovation. Second, the regulatory relief provided to the futures exchanges has, likewise, provided substantial benefits to the capital markets. Together, these two factors confirm that the policy judgments Congress made in 2000 were sound then and remain so today. Finally, ISDA has had a long tradition of working cooperatively and constructively with this subcommittee, and we look forward to the opportunity to continue to do so in the coming months.

I would be happy to take any questions you or the committee may have.

[The prepared statement of Mr. Pickel appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much. Just a general question to all of the panelists: what will the future of this industry look like, and what regulatory challenges does that present? What things should we be looking at as we try to figure out what happens in the next 5 years, 10 years? Mr. Damgard?

Mr. DAMGARD. Well if the past is any indication of where we are going, we will see continued growth because the world is a riskier place, and I think more and more institutions—medium-sized and even smaller institutions are recognizing how valuable futures contracts are for managing their risk. In addition, I think the competitive aspects of what the members of this committee achieved when they wrote the CFMA has allowed more exchanges into the mix, and I hope we will continue to see that, and I believe we have to guard against any efforts to eliminate or curtail the arrival of new entities. Also, I think futures markets are becoming more and more efficient. One of the reasons why we have supported the clearing link is because it reduces the amount of capital required from clearing firms. As an industry, we have benefited dramatically from the two Chicago exchanges using the same clearinghouse because the offsets make it less important for the clearinghouse to hold as much money as they do if you are margining every position.

And to the extent of somewhere around 25 percent of the business coming into Eurex is from U.S. customers. These are from great, big institutional users who are looking for ways in which to make these markets more capital efficient.

So I suspect if we avoid any major scandals, we are going to continue to see our markets grow quite dramatically.

There are issues out there that we haven't talked about, like the potential shortage of front-end providers for order entry into the exchanges, and there are some controversial patents right now that are being challenged by the industry that could have a deleterious effect, but I don't think those are matters that the committee need to worry about at this stage.

Mr. ROTH. From the self-regulatory point of view, I think one issue that is going to bear watching over the next couple of years is just the continued evolution of the self-regulatory process. I have mentioned in my oral testimony and in my written testimony that, obviously, NFA is a huge believer in self-regulation, but the fact is that as the markets become more globalized and more competitive, the types of conflicts of interest inherent in the self-regulatory process start changing too, and there is going to be a great need over the next couple of years to ensure that the regulatory process always remains above the competitive fray. I don't think there is any need for legislation, but I think the CFTC—its job in overseeing the self-regulatory process and its job in making sure that it is managing those conflicts of interest becomes more complex. I am sure that the CFTC is up to that job, but I think managing the changing nature of the conflicts of interest inherent in the self-regulatory process is something that the commission is going to have to spend some resources on in the years ahead.

Mr. GREEN. Mr. Chairman, for me, it revolves around three concepts: convergence of markets, globalization of markets, and the impact of technology on markets. And really, all three of those factors bring down barriers for entry for those who need to raise capital and those who need to invest capital. And as I look around, the providers of the service—the intermediaries—they are recognizing that and realizing that the power has begun to shift to the client, the capital-raising client or the large, institutional investor client, and frankly, away from the intermediary, because technology has brought down the cost of transactions, globalization has brought about many different choices, and convergences has taken down the barriers between different types of products to let clients decide how they are going to follow those things. And I think that the principal-based approach that was adopted in the CFMA is an approach that is becoming catchy around the world. I think that you are going to see more unleashing of creativity to continue to bring down those barriers so the intermediary doesn't define what the client's needs are; the client defines what their needs are.

Mr. GAINES. Mr. Chairman, speaking on behalf of the alternative investment-management industry, in the last 10 years, that industry has grown from \$50 billion assets under management to \$1.2 trillion. This is a reflection of the recognition by institutional investors, primarily, and high-net-worth individuals that long-only equity doesn't get the job done, that there are risks associate there. There are alternative vehicles that can actually be less risky with

a higher promise of return. If you chart \$50 billion to \$1.2 trillion over 10 years, there is no reason to believe that endowments and pension plans and high-net-worth individual will not continue to diversify their portfolios from just fixed-income-long, or equity-long into the diversified benefits that can be derived from the alternative investment industry. So I see tremendous continued growth, which would be reflected in all of the other associations and exchanges and parties that have appeared before you—an increase in volume with them because the hedge fund is a counter-party. It is involved in all of the activities of witnesses who appeared before you, so I would say it would a very rosy picture for the industry.

And one last thing: the primary investors, the bulk of investment in the alternative investment industry, by far, comes from sophisticated, institutional, high-net-worth individuals. We do not see the kind for foreign exchange fraud, for example that Mr. Roth alluded to, because of the nature of the investor. If you have a pension plan with \$50 billion in assets or \$20 in assets, they are well able to do due diligence on a hedge fund, and they do it; I assure you. So we have a tremendous, growing industry, and I don't think it is going to be accompanied by some of the fraudulent activities that accompany large-growth industries. Thank you.

Mr. PICKEL. Mr. Chairman, I would just echo the comments made, but also emphasize the electronic. I think in the same way that over the last 5 years or so you have seen a transformation on the exchange-traded side of the business, we are already seeing—and I think this process will only accelerate over the next 5 years—of use of electronic systems to facilitate the trading of OTC derivatives as well as the settlements and confirmation of trades that are done, whether on the phone or in some electronic manner. So that is a trend that we are certainly going to see.

Mr. MORAN. I thank you. Mr. Etheridge?

Mr. ETHERIDGE. Thank you, Mr. Chairman. Mr. Roth, exactly how would you amend the CEA to ensure that you and the CFTC have adequate enforcement authority? And can you tell us how the industry is coming together to proffer a sort of a solution to the problems?

Mr. ROTH. Watching the industry come together is always an interesting process. We have a special committee that our board appointed to deal with retail foreign exchange issues. Part of their mission was to sort of tighten up our own rules, and part of their mission was to see if there was a legislative proposal that all of NFA could support, the exchanges, the FCMs, the managed money, that they could all support.

We have been kicking around a couple of different drafts of alternative language at a staff level. Within the next couple of weeks, we are going to be showing that to different members of our constituent groups and get those alternatives in front of our committee to try to come up with a proposal. I am confident that we can do it; we have done this kind of thing before. It is hard, but I am pretty sure that if we get enough smart people talking about the issue that we will come up with an solution that everybody can live with.

I can just mention one more thing? In my oral testimony, I talked about the *Zelener* decision. There is another aspect to the statute that is a weakness in customer protection. You know, the

gist of the CFMA was that otherwise-regulated entities could do business with the retail public, and I don't have any problem with that idea at all. If you are an otherwise-regulated entity, if you are on somebody else's radar screen, well, then, by all means, you can do business with the retail public. The way the statute got worded is that it provides that if the otherwise-regulated party or entity is the counter-party to the transaction, then the transaction is outside the act.

Well, that leaves open the possibility that counter-party might be otherwise regulation, but the people actually selling the product, the people doing the telemarketing that have direct contact with customers, soliciting customers—they are completely unregulated. And as long as the counter-party is an otherwise-regulated entity, all that activity is unregulated, and I don't think that is what Congress meant. I don't think that is what you were trying to get at, and I think we need to develop language to address that issue as well, and we are in the process of doing that as well.

Mr. ETHERIDGE. Thank you. Mr. Gaine, I am going to ask you the same question, if I may, that I asked Mr. Duffy earlier. As greater CFTC or SEC cooperation a solution or do we need to let the regulators set rules for the securities between products as they see fit? Do you understand the question?

Mr. GAINE. I didn't quite hear it. Are you asking about the coordination between the SEC and CFTC?

Mr. ETHERIDGE. Yes.

Mr. GAINE. Well, it crops up in a number of areas. The people prior to me have discussed the single-stock futures, which have not worked very well. As you probably know, the SEC recently adopted a rule mandating investment advisor registration for hedge fund managers. This was something that we opposed but lost in a 3 to 2 vote back in October. We are, hopefully, working with the SEC now to make it the most efficient process, and I think the jury is still out on that, but they have represented that we would be able to sit down and work those things out.

There are other issues like the offering of public commodity funds which are both registered under the Securities Act of 1933 and the pervasively regulated by the NFA and the CFTC—and through the years, we, historically, had a lot of problems because the SEC, quite frankly, didn't have the expertise about commodity exchanges domestically and worldwide. But we are hopefully going to make some progress, and I would like to feel free to come back to this subcommittee if we don't really get it done.

Mr. ETHERIDGE. Well, this may be the time.

Mr. GAINE. Well, I have the address, sir, and I thank you. In fact, I am making a note right now, sir.

Mr. ETHERIDGE. Thank you, and I yield back.

Mr. MORAN. Mr. Etheridge, thank you. The gentleman from Washington, Mr. Larsen.

Mr. LARSEN. Thank you, Mr. Chairman. Mr. Pickel, a few questions about swaps derivatives and the application—you probably were here earlier—the application of 2(g) and 2(h). Why would someone choose, say, the legal certainty of 2(h) over the legal certainty of 2(g) to complete an exchange? I am trying to understand why these two exist given that there doesn't seem to be much dif-

ference—but I am trying to sort out those differences, as well. Can you walk through that with me a little bit?

Mr. PICKEL. Certainly. I will try and do that. 2(g) is intended to codify a longstanding policy of CFTC and Congress, what we kind of shorthand-call OTC derivatives that are not appropriately regulated as futures. We often, in describing those contracts—instead of saying OTC derivatives, we talk about bilateral, privately-negotiated, custom-tailored transactions that two parties enter into negotiation; they document that trade. They typically document under an ISDA contract, and that is the world of what people refer to as OTC derivatives.

Now, 2(g), I think, was very specifically and narrowly tailored to focus on that individualized negotiation, and it provides a great deal of legal certainty for a wide range of transactions. As far as the 2(g)/2(h) divide, I think that a party entering into—because of the potential for anti-fraud and anti-manipulation provisions to apply if a transaction is considered to be 2(h), I think parties need to be very careful in those type of transactions and how they enter into negotiations and how they structure them.

I think the traditional way in which parties interact by phone, typically confirming is the way we have dealt in this business for 20 years. As we move to electronic, much of what is done electronically is just in the same way as what is done telephonically, but you do move into the potential for being more of a trading facility or potentially even a quasi-type exchange. So I think in those situations you need to proceed cautiously on your reliance on 2(g).

But 2(g) is, in our view, there where transactions, say, between Goldman Sachs and Exxon-Mobil on oil, which they negotiate and enter into pursuant to an ISDA contract, which provides a number of protections for the two sophisticated parties to the contract.

Mr. LARSEN. So 2(h) applies to an electronic-trading facility. Is that right?

Mr. PICKEL. There is an exclusion there for it if it is not done on a trading facility. It must not be done on a trading facility. I think if you look at the definition of trading facility, there is an exception there that says if you are doing it essentially on an electronic transaction what you would do telephonically, then you are not a trading facility for that purpose.

Mr. PICKEL. But once you get beyond that, I think—

Mr. LARSEN. Right, but then 2(h) would apply with legal certainty?

Mr. PICKEL. If it is done in a way—electronically that is inconsistent with the way traditionally it has been done, telephonically.

Mr. LARSEN. As I understand, as well, trading under 2(h), there are specific exceptions that ensure the application of—I understand as the application of anti-fraud and anti-manipulation. Does that necessarily apply to 2(g) transactions as well?

Mr. PICKEL. Two G is stated to be an exclusion for these individually-negotiated transactions—

Mr. LARSEN. Yes.

Mr. PICKEL. And with the exceptions of a couple of very limited revisions of the CEA, those relation to derivatives clearing organization and the provisions of the CEA do not apply to a 2(g) individually-negotiated transaction. The provisions of the CEA have anti-

fraud and anti-manipulations, any provision of the CEA, other than the two specifically allowed addressed in the legislation, derivatives clearing organization and preemption. In our view, those provisions of the CEA would not apply to those transactions.

I think the reason for that is if you look at—again, two sophisticated parties entering into a contract they negotiate—there are many protects under an ISDA contract for that relationship. There may be protections under State concepts of State law, fraud law. And also, it is just the two parties to that transaction who know the details of that transaction, with the possible exception of a broker who put the parties together. And they are the only ones who know those terms, and there is not that effect on the marketplace that I think would be a significant concern for the CFTC and where I think they would clearly have authority.

Mr. LARSEN. So you believe if there was a concern in the marketplace, the CFTC, then, could be able to step in; there is authority to step in if that 2(g) transaction had that—had some negative impact on the market?

Mr. PICKEL. I think what would be the case is that if there was an effect in the marketplace, it would not be related to the transaction—that individual transaction, itself, but perhaps related to other activity that one or the other party is engaged in, either on a trading facility or on an exchange or something like that, where the CFTC authority would kick in.

Mr. LARSEN. Mr. Chairman, just one more, if I may. Dr. Newsome suggested that the issue wasn't 2(g) and 2(h); the issue might be the 4b provision, the language that says "for or on behalf." If you remove that, that might help settle any issue that exists. Are you in agreement with that or—

Mr. PICKEL. I think, regarding 4b—and that is a provision that has been discussed in connection with some legislation over the last 5 years. And I would urge this committee to take that back into this committee for consideration and not have it dealt with through an energy bill. There are some other provisions there. I think that is a worthy topic of discussion. I would say, however, that, at least in our view, if it is a 2(g), individually-negotiated transaction, whether you make a change to 4b or not, isn't going to affect the fact that that transaction is excluded from the provisions of the act, including anti-fraud and the anti-manipulation, with those exceptions, derivatives clearing organizations and preemption of State law.

Mr. LARSEN. It seems a pretty broad exclusion, 2(g). That is an opinion I am coming to. I don't want to ask you to agree with me or not; I won't put you on the spot there. But it just seems like a pretty broad exclusion, the 2(g) exclusion, so I am having trouble sorting out why it would be there from a consumer's perspective or the users perspective. If there is legal certainty for the traders, the folks who are doing the trading under 2(h)—why you would need 2(g) if you can get legal certainty under 2(h) and ensure that if there are any problems with either individual, the CFTC could use 2(h) to deal with those problems.

Mr. PICKEL. I would just say that you are talking about two parties who are eligible contract participants which I translate as sophisticated parties who are in a position to negotiate with their

counterparty, who might be another energy company, who might be a Wall Street firm, and they can negotiate and negotiate hard for the terms that are relevant to their particular transaction, and they will, again, have the protections of a comprehensive, contractual framework largely developed by ISDA, available to them, as well as, potentially—you know, other concepts of contract fraud if that should be the case.

Mr. LARSEN. Thank you for the extra time, Mr. Chairman. I would like to follow-up with you on this a little future as I get a chance to think about your answers, and I will get back to you, as well.

Mr. PICKEL. I look forward to it.

Mr. LARSEN. Thank you so much.

Mr. MORAN. Mr. Damgard, it is always useful for me to hear or see examples. You talk about a potential need for re-regulating, I guess, some of the rulemaking process for exchange rules.

Mr. DAMGARD. Yes.

Mr. MORAN. What is an example of a rule that would be implemented that would be onerous or a restraint on trade, one that raises concern with you and your industry?

Mr. DAMGARD. Well, I think this is one of the reasons why we are discussion how best to manage the boards of the exchanges. Some of the rules of the exchange could conceivably be anti-competitive if they passed, particularly in a new world where the customer may have the opportunity to use more than one market. And even when that customer may be an investment bank, that sometimes takes the customer's order and decided that it is in the best interest of the customer not necessarily to go to the central market because they are worried that the size of the order would have the effect of depressing the price by time that the order was fully executed.

If an exchange passes a rule based on the business people at the exchange that punishes that particular market participant, in my view, that would be a very, very bad step. One of the things that we have suggested that would, I think, counter that is to have the independent directors of the exchange responsible for all of the SRO activity.

Also, in the punishment area, rules can be anti-competitive and members of an exchange can be disciplined or punished by the exchange for anti-competitive reasons as well. There is one example of a modification of an exchange rule that had to do with moving positions from one clearinghouse to another after the order has been executed, and the CFTC is looking at that right now. One party believes that the rule was done for anticompetitive purposes. The other party said, no; this is the equivalent of a wash trade; simply broadening the definition of the existing rule. And these are things, this is why you created an expert agency. The CFTC will deal with such matters. I think.

Let me, at this moment, apologize to Mr. Gaine. I didn't recognize him since he colored his hair, but it seems that his hearing has deteriorated, he probably can't hear this.

Mr. GAINE. As long as you limit it to the hair and don't go to weight, that would be fine.

Mr. MORAN. Mr. Roth, I share your sentiments—at least my initial reaction to *Zelener* was—in fact, I am surprised by the lack of folks taking the attitude or approach that you do when you say it is important that Congress respond. I am very interested in that. I throw that out for you and others, that my initial reaction is that inability to enforce, as a result of the *Zelener* case, means that Congress has not only an option, but some responsibility to look at that issue legislatively. And I know there will be lots of folks who tell me the reasons that we should or you can't open that can of worms, so to speak; but again, I think that enforcement provision is awfully important. It is the basis for which the CFTC needs to be able to operate.

Mr. ROTH. And obviously, I share that opinion very strong, and I really am confident that the industry can come to a solution here that all parts of the industry can support. I think it is not going to be easy. We want to make sure that it is not over-broad; we want to guard against unintended consequences; but gee, we got to do this because if we don't, there is just going to be an awful lot of people get hurt, and there is going to be—and ultimately it is going to be bad for the industry. So I think it is an issue that just has to be addressed, and it just has to be addressed the right way.

Mr. MORAN. Mr. Etheridge and I commented upon your earlier testimony, in which we thought your list was less than all-encompassing, in which you indicated there were smart people in the industry, smart people at the CFTC. We were waiting for the 3d. Although I agree with you, I was displeased by your testimony.

Mr. ROTH. One tries to avoid stating the obvious, Mr. Chairman.

Mr. MORAN. That was a well put and timely response. Let me ask just a couple of questions, Mr. Roth. I don't understand this issue a lot or well. How do you characterize the firms that bring foreign-currency business through NFA's regulated members? Are they owned by persons who can't pass NFA's fitness standards? And how do you describe those firms?

Mr. ROTH. The situation I was trying to describe was one I alluded to in one of my answers. The way the statute is worded, if the counterparty to the transaction is an otherwise-regulated entity, like an FCM, then the transaction is outside the act, and that allows the possibility that the people working the phone and soliciting customers are unregulated and unregistered. And we have had a number of instances in which these unregulated firms are bringing business to NFA member firms, and the people doing the solicitation, who are not required to be registered, have in fact, had previous disciplinary problems within the futures industry.

So we have this situation where people that have been subject to disciplinary actions for sales-practice fraud and are out of the futures industry sort of come in through a backdoor by soliciting customers for these retail foreign exchange transactions to which and FCM is the counterparty. And I don't think that is what Congress meant. I think the idea was that otherwise-regulated entities can do business with the retail public, and I don't think Congress meant that that if the counterparty is the otherwise-regulated entity, we don't really care who is soliciting the customer. I don't think that was what the idea was, and I think there is a way to fix the statute. I think that would ensure that the people doing

business with the public, that the people soliciting those customers, are in fact, otherwise-regulated entities.

Mr. MORAN. Another topic that you raised that I don't know a lot about—you suggested, in fact, this program be eliminated—CFTC's reparations program. Tell me about that.

Mr. ROTH. You know, the CFTC is the only Federal financial-oversight agency that I am aware of that is required by Congress to have a dispute-resolution program for customers. And I think when that was created by statute, back in about 1974, it probably made a lot of sense. Back during that period, there were a couple of things. No. 1, you had, frankly, a really bad situation with boiler rooms all around the country that were taking advantage of retail customers in the futures industry. Second, NFA hadn't come into existence yet, so there was no industry-wide arbitration forum that was available, so the only way to give customers who had a beef an alternative means of resolving that dispute was through the reparations program.

Well, the reparations program was a big success; it did very well. And back before NFA was created, they used to get 1,000 cases a year. Last year, they got 93. That precipitous decline is, No. 1, because the CFTC and NFA have worked hard to try to get rid of those bad firms that generated those complaints. And No. 2, NFA's arbitration program has become a little bit more popular forum for customers that have disputes that want to resolve them without going to court.

So the bottom line is that we kind of feel that the reparations program was a good program that has perhaps outlived its usefulness and that it may be time for Congress to eliminate section—I think it is section 14 of the act, that requires the commission to maintain that program. All of us that are regulators—you are all trying to spend your resources the smartest way you can. And to require the commission to maintain a reparations program and spend some resources on it to handle 93 cases a year, when they used to handle 1,000. I just think maybe reparations has outlived its usefulness.

Mr. MORAN. Let me ask a general question of the panel. Do any of you hear any testimony from the earlier panel or you colleagues on this panel that you would like to respond to? Mr. Green.

Mr. GREEN. I would not so much respond to, but just subscribe to what Mr. Damgard and Mr. Pickel said about the process of amending the act. The jurisdiction rests squarely in this committee's hands, and floor amendments on energy bills is not the way to craft that kind of careful legislation. The great history of this act is because of the care that was taken in crafting it to make sure that there was proper legal certainty and that exclusions and exemptions were well thought out, and we would just encourage you to stand firm on your jurisdiction. And as it related to the issue of the *Zelener* case, we, too, would look forward to working with the committee in trying to carefully identify exactly what the problem is, because that law of unintended consequences is very serious in this regard. You know, the foreign-exchange market has grown tremendously in relevance to all of us as we see what happens with the dollar on a day-to-day basis. It is a highly sophisticated market that moves trillions of dollars regularly. If there a problem as a re-

sult of the *Zelener* case, you need to narrowly identify what that problem is and address it in a way that doesn't contradict the ability of the marketplace to operate as a whole. And really, is that fundamental basis, that principle basis that we support, so we would want to work with you and urge caution to make sure that the unintended consequences are fully thought out.

Mr. MORAN. Mr. Gaine.

Mr. GAINE. If I might just echo that. The reason there is this industry which—and the Alan Greenspans and John Snows and capital-markets people globally will sing the praises of it. The reason this industry exists is because this committee, in 1974, put the exclusive jurisdiction over futures contracts in the hands of the CFTC. I will debate that with anybody; it is absolutely, demonstrably true.

Micah's point—I remember years ago—John Damgard may not remember—but Pat Roberts was sitting up, around over in this corner, and we got into this same question about jurisdiction, and he quoted from Genesis. I am Catholic, so we don't read the Bible very much—but he was quoting from Genesis about creation, and he said “There is one chairman and one committee here in this body that feels it has the birds that fly, the fish that swim and the animals that walk, et cetera” and that is their jurisdictional reach, anything made under creation. I echo this. These are very complex, difficult decisions that should be kept within the friendly and knowledgeable confines of the House Committee on Agriculture.

Mr. MORAN. I have already complained to my colleagues that the past continues—my predecessor continues to loom over my shoulder.

Mr. GAINE. Well, you couldn't have a better person looming.

Mr. DAMGARD. I think the committee wisely differentiated between the cash markets and the futures markets. And many of the issues today don't clearly differentiate between what the mission of the commission is, and I believe that Congress was very, very smart in making sure that the CFTC's mission was clear. It wasn't to deal with cash markets. It can't be expected to be a national consumer-protection agency. And I agree with—and I think there are ways in which to resolve this within the industry, but I remember the grain scandals in New Orleans in the 1970's, and that wasn't the CFTC's problems. People painting lead bars with gold paint and selling them. These are not issues that we think the commission or even the NFA ought to be wasting their resources on. But I think a very narrow approach to fixing the forex problem is something that we can resolve.

And the other thing that I would like to say about Mr. Duffy's testimony, where he very proudly mentioned that their board was meeting all of the requirements of the New York Stock Exchange listed corporations—our point is not that they aren't meeting the listed corporation. They are an SRO, and if an SRO believes that an independent director is independent, when in fact, that person can be disciplined by the management of that organization, as I said yesterday, that doesn't pass the laugh test. That is not an independent director. They have had some fine independent directors, including a former member of this committee, Dan Glickman and Myron Scholes, who are legitimate, independent directors. And

I am sure that some of the directors who are not independent are very, very strong supporters and fine directors. It is just that they should not be able to count one of the local market-makers, who sits on the floor every day and who can be disciplined by management for whatever reason, as independent.

Mr. MORAN. I thank the panel. Thank you very much for your time and for the opportunity we had to learn from you.

I will call our third and final panel to the table: Mr. George Hanley, president of the Hanley Group, on behalf of the National Grain Trade Council; Mr. Tom Coyle, general manager of Chicago and Illinois River Marketing LLC, on behalf of the National Grain and Feed Association; Mr. Jeffrey Sprecher, chairman and chief executive officer of Intercontinental Exchange, Inc.; And Mr. Martin Doyle, president of OneChicago, LLC. Mr. Hanley, you may begin when you would like.

STATEMENT OF GEORGE HANLEY, PRESIDENT, HANLEY GROUP, CHICAGO, IL, ON BEHALF OF THE NATIONAL GRAIN TRADE COUNCIL, WASHINGTON, DC

Mr. HANLEY. Thank you. Mr. Chairman, good morning. My name is George Hanley, and I am president of Hanley Group, an agricultural market-making group based at the Chicago Board of Trade. I am also member of the National Grain Trade Council, on whose behalf I appear before you this morning.

The Council is a North American Trade Association that brings together grain exchanges, boards of trade, and national grain-marketing organizations with their grain industry counterparts, including grain companies, millers and processors, railroads, futures-commission merchants, and banks. We welcome the opportunity to share our views with you today.

The National Grain Trade Council strongly supports a movement from prescriptive regulation to the core principals of the Commodity Futures Modernization Act of 2000. We are very pleased with how the CFMA has been implemented and how the industry has prospered under it. In keeping with the spirit of the CFMA, the Council believes that enumerating agricultural commodities under the CFMA no longer serves to advance public policy.

Agricultural markets have matured, especially under the CFMA, and the more prescriptive regulation is no longer necessary to protect the markets or the market participants. Modern U.S. agricultural futures and options markets are much deeper, draw significant representation from worldwide commercial hedging interests, and offer greater trading opportunities for a speculative community, whose participation is as essential for the success of our markets as farmer and commercial hedging communities.

As the CFTC moves towards becoming more of an oversight authority under the CFMA, Congress may want to consider whether the regulatory structure should recognize the maturity of the agricultural market and put them on a parity with the other physical commodity markets. The Council strongly believes that price discovery, the fundamental goal of a regulatory structure, is best accomplished by vesting responsibility with exchanges and providing the Commodity Futures Trading Commission with the necessary tools for oversight authority and meaningful regulation. With that

in mind, the council continues to believe that exchanges should be responsible for setting speculative positions limits, subject to the Commission's oversight. We believe such action would result in a reduction in duplication in regulatory oversight as well as greater market transparency.

Currently, the exchanges must go through the self-regulatory process to change their rules to allow for an increase in limits. Then, they must petition the CFTC to modify its rules to permit such an increase. Elimination of this regulatory redundancy would fully implement the core principals of the CFMA for all agricultural commodities and allow exchanges to respond quickly to the ever-changing market conditions, while retaining CFTC oversight.

Furthermore, allowing exchanges to increase speculative position limits would also increase activity in a transparent marketplace and allow exchanges to compete more efficiently with over-the-counter markets.

We would also like to bring to your attention our concern that funds are taking a position in agricultural indexes of significant size to justify petitioning the CFTC for hedge exemption. In our view, this has the potential to present a misleading perception of commercial participation versus speculative participation in agricultural markets. As this issue moves forward, we believe the definition of a commercial participant should be carefully assessed.

Another issue that warrants further review by the CFTC is the agricultural trade options pilot program. The Council supports the comments of Acting Chairman Brown-Hruska on the need to make viable risk-management tools, like ATOs, available for producers. However, the program has not met the expectations of the producers industry or the CFTC. Over the years, the Council has watched the CFTC and the industry wrestle with ideas on how to make the ATO program more productive, but at this point, the Council believe that now is the time to consider a fresh start.

The Council suggests tapping into the innovation that we have seen in the energy and metals markets and putting to work to deliver a risk-management tool for agricultural producers that is both valuable and effective. In our view, before such tools can be developed, the CFTC and the industry must begin by defining the pool of potential market participants, including examining who should be a commercial participant and what is the appropriate level of credit worthiness. The council, working in concert with you, the CFTC, industry, and other affected parties, is eager to develop such a program.

Another opportunity for meaningful regulation under the CFMA involves application transparency for new exchanges. The CFMA lowered many regulatory hurdles, making it easier for new entrants to participate in the marketplace, and we support this effort. With 4 years of experience with the new regime, now is the time to draw from those experiences and examine the application process for new exchanges to ensure that there is enough opportunity for discussion and debate. The Council champions market competitiveness, but believes that the application process should ensure that the CFTC, the marketplace, and public receive full and consistent information about new applicants. Though we understand that financial accounting statements are outside of the jurisdiction

of CFTC, as part of our testimony today, we want to bring to your attention the negative impact Financial Accounting Statement 133 is having on commodity markets. Under the current rules, grain and food processors must either misrepresent their financial state to comply with FAS 133 or opt to not participate in the market.

For example, FAS 133 requires a grain or food processor to report the in-term gain or losses from the futures hedge, but the firm may not report the off-setting losses or gain from the change in the price of the physical commodity, as though the movement in the price of the hedge instrument has no relation to the movement of the physical commodity that was hedged. This defeats the purpose of hedging.

Under FAS 133, financial firms are allowed to hedge various components that determine a financial assets price. Allowing the agricultural commodity hedgers the same opportunity given to financial firms under FAS 133 would promote greater market participation and more accurate reporting of financial conditions.

The Council would welcome the opportunity to discuss this issue with you in greater detail. In conclusion, Mr. Chairman, we compliment you for your effort. The Council supports the advances made under the CFMA. We are very pleased with the direction in which we are headed and look forward to working with you on solutions that continue to push the industry toward evermore efficient and meaningful regulation.

[The prepared statement of Mr. Hanley appears at the conclusion of the hearing.]

Mr. MORAN. Thank you, Mr. Hanley. Mr. Coyle.

STATEMENT OF TOM COYLE, GENERAL MANAGER, CHICAGO AND ILLINOIS RIVER MARKETING LLC, CHICAGO, IL, ON BEHALF OF THE NATIONAL GRAIN AND FEED ASSOCIATION

Mr. COYLE. Good afternoon, Mr. Chairman. We appreciate the opportunity to present our view on reauthorization of the Commodity Futures Trading Commission and risk management issues confronting agriculture. I am Tom Coyle, general manager of Chicago and Illinois River Marketing, LLC in Chicago, and I serve as chairman of the National Grain and Feed Risk Management Committee. The NGFA's more than 900 grain, feed, and processing firms operate over 5,000 facilities that handle more than two-thirds of all of U.S. grains and oilseeds. Our industry, as a first purchaser of grains and oilseeds from the producers has traditionally provided both grain marketing and risk management services to farmers through a variety of cash instruments. The NGFA's membership also represents a substantial portion of the hedge-business volume on the grain exchanges, and so we have strong interest in the performance of both futures and cash markets.

The NGFA strongly supports reauthorization of the CFTC. The agency performs an important oversight and regulatory role that benefits the grain, feed, and processing industry as well as producers and consumers. Our organization maintains a strong, professional working relationship with the CFTC, and we have been generally pleased, in recent years, with the leadership and direction taken by the agency.

The 2000 Commodity Futures Modernization Act provided additional regulatory flexibility in the CFTC's regulation of exchanges in all commodities except the enumerated commodities, grains and other agricultural commodities. We are not going to argue that the time has now come for enumerated commodity markets to be treated with the identical regulatory structure of all other markets; however, there is no doubt that the greater regulation of enumerated commodity markets creates more hurdles in making rapid, adaptive changes to respond to perceived customer needs and adds to the cost of operating the exchanges.

We think it is to the advantage of the U.S. producer and consumer to have strong and liquid futures markets here in the United States to maintain marketing and pricing efficiency. Given the responsiveness of the exchanges to their customer base, we would submit that that the agricultural markets should be candidates for a more flexible and less costly regulatory structure. The increasing competition in the marketplace tends to provide additional discipline that should eliminate some of the need for regulations under the CFTC.

The Commodity Futures Modernization Act of 2000 addressed a potentially major problem in nonagricultural off-exchange derivative markets. It provided legal certainty for such derivative contracts to be legally enforceable after both parties have executed the contract. While agricultural markets are considerably smaller than these financial derivative markets, cash agricultural contracts remain saddled with the risk that the CFTC or the court system may review a particular contract and declare, after the fact, whether the contract is viewed as legal, exempt from the CFTC jurisdiction, or illegal and therefore not enforceable.

We think it is important that the marketplace have more direction from government as to the legal standing for agricultural cash contracts. Increasingly, cash contracts that are offered to farmers have features that provide the farmer and merchant with greater flexibility. That flexibility has value to both parties. Unfortunately, the flexible features that provide more value and utility are the same contract features that potentially raise questions regarding the contract's legal standing. Contract features such as providing for multiple rolling opportunities, allowing a contract to be rolled forward, and offering the ability to cash in the contract, have real economic value, but depending on the circumstances can raise legal questions. The bottom line is that we think greater legal clarity will provide the marketplace the ability to offer value through cash contracting.

There are two potential ways to resolve the need for greater legal clarity for these contracts that are exempt from CFTC jurisdiction. One way is to amend section 1(a)-11 to more crisply define exempt forward-cash commodities. The other method would be for the CFTC to develop more specific guidance for the cash marketplace that gives consideration to the most recent, relevant cases before the CFTC and the Federal Circuit Courts. In our judgment, the latter approach, through a regulatory proceeding at the CFTC, holds considerable promise, given the progress that recent court and CFTC cases have made.

As this subcommittee is keenly aware, government budget cuts and the negotiations coming up in the next round of the WTO could affect the level of government direct support to U.S. farmers. If this occurs, producers may find that they have greater need for market-based risk management tools. Given the situation, it seems timely to at least review the market-based management tools now available and to make note of the regulatory barriers that are today restricting access to some producers.

Mr. Chairman, we appreciate the opportunity to present our views on the CFTC and related risk-management issues. I would be happy to respond to any questions.

[The prepared statement of Mr. Coyle appears at the conclusion of the hearing.]

Mr. MORAN. All right. You are welcome, Mr. Coyle. Mr. Sprecher.

**STATEMENT OF JEFFREY C. SPRECHER, CHAIRMAN AND
CHIEF EXECUTIVE OFFICER,
INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA**

Mr. SPRECHER. I will be very brief in the interest of time, Mr. Chairman. My name is Jeffrey Sprecher; I am the founder, the chief executive officer, and the chairman of IntercontinentalExchange, which is also known as ICE. We are headquartered in Atlanta, and we operate a leading global-electronic platform for over-the-counter marketplace and for trading of energy commodities and derivative contracts based on energy commodities. The energy commodities on our platform include oil, natural gas, and power. ICE also operates in energy commodities futures exchange through our wholly-owned, London-based subsidiary, the International Petroleum Exchange of London, which is also known as the IPE.

I would like to thank the committee for its effective and far-sighted work in developing and adopting the CFMA. The CFMA is critical to my company's success. ICE operates as an ECM under the jurisdiction of the CFTC. As an ECM, ICE is required to comply with access, reporting, and recordkeeping requirements. With respect to the issues affecting ECMs in particular, ICE is of the view that the CFMA and the rules adopted by the CFTC provide an effective framework for the oversight of commercial marketplaces and there is no need to amend the Commodity Exchange Act in this area. The CFTC has promoted open, freely-accessible, and transparent markets, including the permission of ECMs like me. I believe restricting trading activity through additional regulation would only adversely affect the market liquidity and price transparency and would not reduce price volatility in energy.

On behalf of ICE, I would like to thank this committee for the excellent work that it has done in enacting the CFMA. It has been a clear benefit to our company, and I submit to the producers and the users of energy commodities around the world. ICE looks forward to working with this committee during the reauthorization process, and I will be happy to take your question when appropriate. Thank you.

[The prepared statement of Mr. Sprecher appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much. Mr. Doyle.

**STATEMENT OF MARTIN DOYLE, PRESIDENT, ONECHICAGO,
LLC, CHICAGO, IL**

Mr. DOYLE. Thank you, Mr. Chairman. I am Martin Doyle, president of OneChicago LLC, the U.S. exchange for single-stock futures and other securities futures products. On behalf of OneChicago, our chairman, Peter Borsch, and our joint-venture owners, thank you for inviting us to present our views today.

OneChicago is a true product of the Commodity Futures Modernization Act of 2000. In that Act, Congress authorized trading in futures on securities by ending the almost 20-year statutory ban on those instruments. It is no exaggeration to say that without this subcommittee's work on the CFMA, OneChicago would not be here. We thank you and your predecessors for your work on that groundbreaking legislation.

OneChicago is a joint venture of the Chicago Board Options Exchange, Chicago Mercantile Exchange, and the Chicago Board of Trade. We provide an electronic trading facility for single-stock futures and other security-futures products. We are the only U.S. market in these products. OneChicago began trading on November 8, 2002 with 34 listing, or 34 futures on individual stocks. Today, OneChicago lists 136 single-stock futures contracts. All of the underlying stocks are included in the SMP-500, ranging from Apple and Boeing to Starbucks and Wal-Mart.

Our progress has been steady. In 2003, OneChicago traded about 1.6 million contracts for an average daily volume of 6,425. Our 2004 volume increased to about 1.9 million contracts with average daily volume of 7,630. While this does represent a 19-percent increase, our volumes in growth pale when compared to those in overseas exchanges. In 2000, when the CFMA was being debated, foreign markets had already announced their intention to trade security futures. We know this subcommittee and others in Congress did not want to see U.S. markets fall behind overseas exchanges. The U.S. is the home of financial innovation, the birthplace of financial futures trading. Having to play catch-up with foreign markets was not a desirable option.

A look at the volume numbers of foreign exchanges, contained at page 3 of my written testimony as well as in the chart that I provided before the panel here—as this chart shows, even accounting for their head start, our foreign counterparts are outpacing us in terms of volume and growth. There are many possible explanations for this, but the fact remains that some aspects of the CFMA, itself, and its implementation have hindered our ability to grow our market. That is why I am here today.

We have started a new business with a new product under special restrictions imposed by both the CFTC and the SEC. We have made a solid start, but we need some help. Our request falls into two categories: non-statutory and statutory. My written testimony describes these in more detail. Margin is a major area of concern. We have asked the CFTC and SEC to allow us to apply portfolio margining to securities futures products. This will save money and promote financial integrity. We need this relief now. We also need relief in the critical area of market-maker margin, where the rules are too complicated and burdensome. Finally, we need a bright line safe harbor so that CFTC-registered commodity trading advisors

can participate in our market in the same manner that they do in every other futures markets without triggering registration with the SEC as investment advisors.

In terms of statutory changes, margin, again, is the big issue. First, current margin levels of 20 percents are too high and serve as a disincentive for many new market users. We would ask Congress to change the statute to ensure margins in the range of 15 percent of notional value. Second, some firms have indicated that securities-based suitability rules are an impediment to their use of these new futures markets. The futures industry operates under know-your-customer standards. Firms should be allowed to meet either form of customer protection rule in order to handle security futures brokerage. Last, the tax treatment of securities futures should be reformed to extend 60–40 treatment to all members of a securities futures exchange.

Mr. Chairman, thank you for your consideration of these issues. With your help and guidance, I am very hopeful that U.S. securities futures trading will be able to serve well the risk management needs of our market participants and the national interest in making sure that the United States continues to lead the world in financial innovation. I look forward to answering any and all questions you may have.

[The prepared statement of Mr. Doyle appears at the conclusion of the hearing.]

Mr. MORAN. I thank you, Mr. Doyle. Mr. Doyle, reiterate again for me the suggestion you have for changes that would require congressional legislation.

Mr. DOYLE. The congressional or statutory changes that we would recommend, Mr. Chairman, would include three things. First of all, the reduction of the current 20 percent level of margin to a more futures-style 15 percent. Second, we would ask that firms that have accustomed to following the futures-style know-your-customer rule for customer protection purposes—be allowed to meet that standard, as opposed to the new suitability rules, which they have been forced to learn and learn to comply with as a result of the CFMA. And third, we would ask that the 60–40 treatment be applied to all of—members of any securities futures exchange, encourage market-making and so forth.

Mr. MORAN. If Congress and the CFTC followed your recommendation, what does that do to your ability to compete internationally? Does that eliminate what—I suggest your testimony—what it suggests to me is that there is a disparity. Other exchanges are growing at a faster rate than OneChicago, and I assume that the issues you present to the committee are designed to level that playing field?

Mr. DOYLE. That is correct.

Mr. MORAN. And would that be the case with—is that the distinction between what is happening in other countries and here in the United States?

Mr. DOYLE. Well, I am not—I can follow up with certain information, Mr. Chairman, but I am not an expert on the tax situations and the regulatory situations in all of the jurisdictions that would be covered by that chart that I provided. However, I am aware that in—I am generally aware that in the United Kingdom, where the

Life Exchange operates, the margin requirements in that jurisdiction are much more futures-style and lower than ours at OneChicago; and therefore, a lowering of our margin to a more futures-style margin, I think, would allow us to compete and not fall further behind.

Mr. MORAN. Mr. Doyle, what is a description—characteristics of a person who uses your exchange? What does your customer look like?

Mr. DOYLE. Well, we have an array of different types of customers at this point, from educated retail users to—all the way up to the largest institutions. Right now—if I understand your question—our volumes and our growth are being driven more by professional trades and institutions who would appreciate things like portfolio margining, 60–40 treatment for members, things like that.

Mr. MORAN. Mr. Sprecher, what is the characteristics of your customer base? Who uses your exchange?

Mr. SPRECHER. We have about 900 companies that are registered to trade on our platform, and it constitutes about 5,000 individuals. The company is young; it is only 5 years old. When we started the firm, the initial customer base were largely energy companies with brand names that everyone would recognize. More recently, into the energy space, you are seeing the emergence of investment banks, commercial banks, and hedge funds whose names very few of us would recognize.

I would say that the growth in energy trading is being driven by the banking and financial community. At this point, I would submit that today there are as many people who could tell you an approximate price of oil as there are that could tell you the Dow Jones industrial average. So it has become a geopolitical contract that has wide implications in many markets, and you are seeing the effect of new market entrants coming from the financial community.

Mr. MORAN. Are there others in your business out there? Who are your competitors? People in other exchanges doing what you are doing?

Mr. SPRECHER. No. We, really, somewhat stand alone. The premise of the company when I founded it was to organize markets that were traded outside of traditional exchanges. And those markets are either traded peer to peer by major oil companies, let us say, or through voice brokers—and there is a large voice-brokerage community out there that still handles that trade—so they are our traditional competitors, and we are trying to bring those markets into a more organized, transparency marketplace and then use the efficiency of electronics.

Mr. MORAN. I assume that you are regulated differently than NYMEX?

Mr. SPRECHER. That is correct.

Mr. MORAN. And what is the justification for that?

Mr. SPRECHER. NYMEX, as I am sure you are aware, is self-regulated organization. ICE, as an ECM, has direct oversight by the CFTC under this category called ECMs. The rest of the marketplace, the voice brokers and the peer-to-peer business, is largely unregulated, so there is sort of a—I guess a scale from black to white to—with grey in between, as it now exists.

Mr. MORAN. There will, I assume, be discussion about additional regulations of the energy markets. Do you have an opinion?

Mr. SPRECHER. We think that the CFTC and the CFMA, as it specifically relates to my company, is good, and we have a good relationship, and we have benefited by the CFTC's enforcement action in the energy space to clean it up. We benefit by markets with integrity. There is some talk in the halls, if you will, about possibly giving the CFTC more enforcement capabilities as it relates to energy and other areas, and if the CFTC needs those, we would certainly support them in that and be prepared to work with people. But specifically, as it relates to my company, I think the operation of the CFMA is good.

Mr. MORAN. Mr. Hanley and maybe Mr. Coyle, we have heard and know about the exponential growth of the futures industry, and I know that there has been growth in the ag sectors of that industry. How does that growth compare, ag versus other traded instruments?

Mr. HANLEY. I would say ags probably fall behind financials in stock-index trade and energy. The ags probably fall behind pretty much everybody else.

Mr. MORAN. The other segments are growing faster?

Mr. HANLEY. Yes.

Mr. MORAN. And your explanation?

Mr. HANLEY. Well, my personal experience is when you open up markets to electronic platforms or an side-by-side open-outcry electronic-platform choice that the trade grows, you will see more arbitrage between the two platforms which creates more liquidity, which then creates more customer interest in the products. And I also believe that ags are more regulated than financials are or energies are.

Mr. MORAN. Remind me. Is ag not traded on the electronic exchange?

Mr. HANLEY. No.

Mr. MORAN. It is only open outcry?

Mr. HANLEY. Yes.

Mr. COYLE. Except for—I think for except for in the evenings where we do have electronic markets.

Mr. HANLEY. Except for—

Mr. COYLE. Except for in the evening, and we do—the Board of Trade has an electronic platform. They have now done—the Winnipeg Exchange is now electronic, using the Board of Trade's platform. Both the Kansas City and Minneapolis Grain Exchanges are using night sessions using electronic format.

Mr. MORAN. And do you see growth in that sector of agriculture? The electronic platform?

Mr. COYLE. I see growth in ag in general. I see growth in production, growth in consumption around the world, and new products coming on stream. You know, the Board of Trade, in May, will offer a contract on the South American soybean contract in the Chicago market, so that should increase trading as well.

Mr. MORAN. Mr. Hanley indicated that the ag sector was more heavily regulated. Is there a justification for that? Either one of you?

Mr. COYLE. We would say no. We would say that there certainly is an history where there was a sense that the users of the agricultural markets were maybe less sophisticated and needed more protection. Today, as we have said in our testimony, we believe that the exchanges have become much more responsive to their customers, and the customers themselves have become much more sophisticated. For that reason, we believe that it is time to consider whether the enumerated commodities should be given the same freedoms as other markets.

Mr. MORAN. Along that line, you do indicate in your testimony that agricultural markets should be candidates for more flexible, less costly regulation. What are the examples where that would occur?

Mr. COYLE. I would say that Mr. Hanley might be able to better answer that question. But the exchanges, themselves, as you have heard in a number of cases earlier today, have taken advantage of the CFMA to expand their markets. For instance, the example of limits that I heard earlier that Mr. Hanley did mention, that there is an approval process that is a bit cumbersome. That, frankly, takes time, then to expand the ag markets, and it also takes up energies and adds costs to the exchanges, but they can probably be better used on growth initiatives.

Mr. HANLEY. I pretty much agree with Mr. Coyle. Whether it is duplication in regulation, insofar as I think what Commissioner Hruska is proposing is that the exchanges pretty much lead on the position limit, but that the CFTC reserves the right to step in. It would take away some of the regulation. I think the ag trade-option program has been pretty much just a program that didn't work, and I am sure that all of the work that was put into it, they wanted to come out with a product that would be used, and widely used. And I think that needs to be looked at again, and we would be happy to give some suggestions on a product that would work.

In general, when you read about the growth of the over-the-counter trade in the energy markets—and my firm does not trade energy products—I am somewhat envious of the energy markets, that they have somewhat of a clear and open field to trade. And what has happened with a lot of the over-the-counter energy trade is it has gone and it has cleared at the NYMEX or at IPE, possibly, or at intercontinental exchange. So you have this free and open market, but then it is being guaranteed by the stability of the clearinghouses—so that is a good thing.

I think a good example is mortgages. If you look at mortgages and you look at financial markets and how the regulations have been taken off financial markets, just look for the everyday man how efficient mortgages are now. That is because they trade freely, and there is a lot of competition. It seems like whenever you can bring more competition in and usually there are some regulatory reasons why there is less competition.

Mr. MORAN. Is there a distinction in the characteristics, the sophistication of those who are trading agricultural futures as compared to financials or single-stock? Who is now utilizing the exchanges in the agricultural world?

Mr. HANLEY. Well, I think the exchanges, I am an exchange guy, so exchanges have their level of regulation. That is the first step,

you have to conduct business with integrity, or you are going to have problems. Not just problems with the CFTC, but you can have problems from your customer. So most people will come to the exchanges. You have the clearinghouse that guarantees the trades. You have the FCM community that also has their rules that are in place, and so most of the trades come to the exchanges. You see the farmers that will come to the exchanges. You see producers and consumers and the professional market makers, and the—I will call them professional—the hedge funds traders.

Mr. MORAN. And what volume of your business is related to the cattleman in Dodge City, KS who has a 1,200-head feed yard? Are those people utilizing the exchange?

Mr. HANLEY. My two companies—one is solely grain products, mostly ag options, and the other company is a global market-making firm. So we don't do any meats—

Mr. MORAN. Well, let me change it to the 1,000-acre grain farmer, then.

Mr. HANLEY. So we would be, hopefully, providing markets for them in corn, soybeans, wheat or soybean meal and oil ag options at the Chicago Board of Trade. And you know, we have seen the explosion in the options volume as a percent of the trade, and you know, that it is possibly an area, thought, we can bring more participants to. Ideally what I would like to see is the farmer be able to take advantage of the liquidity of the markets to hedge their risk.

Mr. MORAN. This subcommittee has an interest in pursuing non-crop insurance risk management tools for farmers, and in part, my interest—perhaps we can explore this further is who are using? What are the characteristics of the kind of farmer or rancher that is utilizing exchanges? Mr. Coyle.

Mr. COYLE. Yes, I can answer some of that. First, I can go back to your cattle questions. I once worked for Continental Grain which is the largest cattle feeder in the country, and I can tell you that they hedged all of the corn that they used. They buy grain every day from farmers, and other times they are buying from country elevators, but they are using the Board of Trade. And in fact, they have a desk, today, as just an animal company on the Board of Trade floor.

In terms of farmers that use it, well, you do have some farmers that use it; most of the farmers do not use it. There is a certain amount of discomfort, I think, with the Board of Trade. Also, and probably more importantly, is when a farmer wants to market their grain, and not just manage the futures price risk, but they want to be able to manage the logistics risk, the basis risk. There is also the issue of margining. You know, today what happens and we have seen a recent rally in prices, and the farmer is taking significant advantage of that, selling grain for next October, November, and December. But when the farmer sells that to a commercial grain company, the commercial grain company is the one that manages the margin on that. There is no cost to the farmer as the prices go higher; it is the commercial grain company that has to then provide the margin money. So there is a lot of comfort and confidence in their local grain elevator and the fact that they can manage these other risks as well as just the basis risk.

You know, one of the things that we talked about earlier is now as we get more clarity and give more flexibility to farmer, legal clarity, then we can offer more flexibility to the farmers. That same business ends up in the Chicago Board of Trade. If the farmer has some of the newer contracts, which have more options embedded in their contracts, not only are the futures hedged in the Chicago Board of Trade, but so are the options. To the extent that the grain industry, our members for instance, have more flexibility, more comfort to provide more creative contracts to farmers, that directly relates to an increase in volume and a stronger Board of Trade.

The other thing that we are noticing in the markets, which I think one of the gentlemen mentioned is there is more index-fund participation in the grain markets. It is adding a lot of liquidity to markets. They have asked for an increase in limits in the Board of Trade you have pension fund that wants to invest, you know, \$20 million. Well, the limits in the Board of Trade today, may simply not be big enough for how they manage their funds, so they have been lobbying for that increase.

Another way that I can tell you that we at the National Grain and Feed have said, fine. We support, you know, these increasing limits as long as there is oversight by the CFTC. So I don't know if that answers your questions.

Mr. MORAN. It does. Thank you very much. Any of you hear anything from your fellow panelists that you would like to respond to? I thank you very much for your time. Thank you for spending at least a portion of your afternoon with us. I appreciate the education that you have provided. I thank you.

I would also like to thank our committee staff for their help in organizing our subcommittee hearing today, Kevin Kramp and Matt Smith and Dave Ebersole and Tyler Wegmeyer.

Without objection, the record of today's hearing will remain open for 10 days to receive additional material and supplemental written responses from witnesses to any question proposed by a member of the panel. The hearing of the Subcommittee on General Farm Commodities and Risk Management is now adjourned.

[Whereupon, at 1:09 p.m., the subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

**TESTIMONY OF CHARLES P. CAREY
CHAIRMAN OF THE CHICAGO BOARD OF TRADE
BEFORE THE SUBCOMMITTEE ON
GENERAL FARM COMMODITIES AND RISK MANAGEMENT
OF THE HOUSE AGRICULTURE COMMITTEE**

March 9, 2005

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

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

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

futures products for the first time. All in all, this legislation and its implementation by the Commission has been a clear success. While the industry has benefited greatly from the reforms of the CFMA, there continue to exist some areas of uncertainty, overlap and the risk of regulatory inconsistency that deserve discussion.

Regulatory Reform and Process

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

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

Legal Certainty and Fraud Jurisdiction

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

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

Stock Futures Products

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

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

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

Issues Related to Cross-Border Business

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

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

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

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

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

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

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

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

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

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

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

Self-Regulatory System

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

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

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

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

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

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

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

Conclusion

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

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

Thank you for this opportunity to appear before you.



National Grain and Feed Association

Testimony

of the

National Grain and Feed Association

before the

Subcommittee on General Farm Commodities
and Risk Management

House Committee on Agriculture

U.S. House of Representatives

March 9, 2005

Good morning, Chairman Moran and members of the subcommittee. We appreciate the opportunity to present our views on the reauthorization of the CFTC and related risk management issues confronting agriculture. I am Tom Coyle, General Manager of Chicago & Illinois River Marketing LLC, in Chicago, Illinois, and I serve as Chairman of the National Grain and Feed Association's Risk Management Committee.

The National Grain and Feed Association is a U.S.-based non-profit trade association of more than 900 grain, feed and processing firms comprising over 5,000 facilities that handle more than two-thirds of all U.S. grains and oilseeds. Founded in 1896, the NGFA encompasses all sectors of the industry, including country, terminal and export elevators, feed mills, cash grain and feed merchants, livestock integrators, grain and oilseed processors and futures commission merchants.

Our industry, as the first purchaser of grains and oilseeds from producers, has traditionally provided both marketing and risk management services to farmers through a variety of cash contracts. NGFA's membership also represents a substantial portion of the hedge business volume on the grain exchanges, so we have strong interest in the performance of both futures and cash markets. In our testimony today we will address three broad issues: 1) Futures exchange performance and oversight by the CFTC; 2) Greater legal clarity for cash grain contracts; and 3) Producer risk management in an era with potentially lower government support for production agriculture.

Futures Exchange Performance and Oversight by the CFTC

The NGFA strongly supports reauthorization of the CFTC. The agency performs an important oversight and regulatory role that benefits the grain, feed and processing industry as a primary user of agricultural products on regulated exchanges. Our organization maintains a strong, professional working relationship with the CFTC, and we have been generally pleased in recent years with the leadership and direction taken by agency leadership.

U.S. futures exchanges are experiencing higher volumes of trading in both agricultural and other commodities. In accommodating this growth, the order entry and execution systems of the exchanges have at times been challenged during high volume, rapidly moving markets. On April 15, 2004, at the Chicago Board of Trade, NGFA members reported excessive delays in some orders being entered, order execution and in reporting fills of orders as well as some wide bid/offer spreads. Most of the problems seemed to be occurring with smaller-sized orders.

The NGFA contacted the CBOT, urging that the exchange give the execution and performance issues a high priority. Within two days, NGFA received a response from the CBOT president that outlined a number of specific measures the exchange planned to implement to resolve the matter. In December 2004, the CBOT reported to a meeting of NGFA member country elevator managers what it had done to implement changes. The CBOT will report again at the NGFA convention on March 31 concerning its implementation of changes and resulting market performance improvements.

We do not raise this issue here today to complain about futures market performance. To the contrary, we think it demonstrates the exchange being highly responsive to its customer base and taking the issues raised by hedger customers very seriously. In our view, all the grain exchanges – Chicago Board of Trade, Kansas City Board of Trade, and Minneapolis Grain Exchange – are actively reaching out to their customer base to receive feedback and respond to needs of market participants. These exchanges realize they are in a competitive world and are making serious effort to provide efficient, liquid markets that serve customer needs.

The 2000 Commodity Futures Modernization Act provided additional regulatory flexibility in the CFTC's regulation of exchanges in all commodities, except for the

enumerated commodities (grains, and other agricultural commodities). We are not going to argue that the time has now come for enumerated commodity markets to be treated with the identical regulatory structure as all other markets. However, there is no doubt that greater regulation of enumerated commodity markets creates more hurdles to making rapid, adaptive changes to respond to perceived customer needs and adds to the cost of operating the exchanges.

Will this create cost-competitive challenges for U.S. exchanges in the future? The U.S. exchanges are in the best position to draw that conclusion. We do think it is to the advantage of the U.S. producer and consumer to have strong, liquid futures markets here in the U.S. to maintain marketing and pricing efficiency. Given the responsiveness of the exchanges to their customer base, we would submit that the agricultural markets should soon be candidates for a more flexible and less costly regulatory structure. The increasing competition in the marketplace tends to provide additional discipline that should eliminate some of the need for regulations under the CFTC.

Greater Legal Clarity for Cash Grain Contracts

The Commodity Futures Modernization Act of 2000 (CFMA) addressed a potentially major problem in non-agricultural off-exchange derivatives markets. It provided legal certainty for such derivative contracts to be legally enforceable after both parties had executed the contract. Because of the growth and growing economic significance of financial derivatives, this action was deemed necessary to give greater assurance of the ongoing performance of huge markets that underpin the functioning of the general economy.

While agricultural markets are considerably smaller than these financial derivative markets, cash agricultural contracts remain saddled with the risk that the CFTC or the court system may review a particular contract and declare after the fact whether the contract is viewed as legal (exempt from CFTC jurisdiction) or illegal, and therefore not enforceable.

We think it is important that the marketplace have more direction from government as to the legal standing for agricultural cash contracts. Increasingly, cash contracts that are offered to farmers have features that provide the farmer and the merchant with greater flexibility. That flexibility has value to both parties. Unfortunately, the flexible features that provide more value and utility are the same contract features that potentially raise questions regarding the contract's legal standing. Contract features such as providing for multiple pricing opportunities, allowing a contract to be rolled forward, and offering the ability to cash settle the contract have real economic value, but depending on the circumstances can raise legal questions. The bottom line is that we think greater legal clarity will provide the marketplace the ability to offer more value through cash contracting.

Since 1996, the most litigated legal issue regarding cash contracting was whether the rolling feature built into cash forward contracts made the contract illegal per se. The vast majority of the cases decided since 1996 found that rolling was a legal feature, but the message to the industry was clear: legal uncertainty creates litigation risk and litigation risk can be expensive. Even when you “win” you may have to pay legal fees of several hundred thousand dollars to prove the point.

There are two potential ways to resolve the need for greater legal clarity for contracts that are exempt from CFTC jurisdiction. One way is to amend Section 1a(11) to more crisply define exempt forward sales of cash commodities. The other method would be for the CFTC to develop more specific guidance for the cash marketplace that gives consideration to the most recent relevant cases before the CFTC and the Federal Circuit Courts. In our judgment, the latter approach – through a regulatory proceeding at the CFTC – holds considerable promise, given the progress that recent court and CFTC cases have made.

The NGFA sent a letter in January 2005 to Acting Chairman Sharon Brown-Hruska requesting that the CFTC undertake such action, and expressing our interest in participation. A copy of that letter was sent to other CFTC Commissioners. To date, we have received generally positive responses from the CFTC regarding a willingness to actively pursue greater legal clarity. Hopefully that process will be initiated soon. While we are not requesting legislative changes at this time, we would welcome the support and participation by Members of Congress or their professional staff in a CFTC effort to accomplish greater legal clarity through regulation.

We would commend the CFTC for making some progress in the last three years through several individual cases. The courts have also contributed to increased clarity, especially in two cases that were decided by the 7th Circuit U.S. Court of Appeals.

In the so-called Nagel II case, the 7th Circuit Court identified the following criteria as providing necessary and sufficient parameters for cash contracts to be declared fully legal and exempt from CFTC oversight and regulation:

- 1) The contract specifies idiosyncratic terms regarding place of delivery, quantity, or other terms, and so is not fungible with other contracts for the sale of the commodity;
- 2) The contract is between industry participants, for example farmers and grain merchants; and
- 3) Delivery cannot be deferred forever because the farmer must pay a fee for extending (rolling forward) the contract.

Furthermore, in the Zelener case, the 7th Circuit court found that the fundamental difference in futures and cash contracts was not the “delivery” feature (because both futures contracts and cash contracts call for delivery), but was in fact that the futures market essentially was “trading the contract” and the cash contract was trading an actual physical commodity. The Zelener case also raised the issue as to whether the original

CoPetro decision that established the “multi-factor” approach so often used by the CFTC was in fact an unnecessary extension of the law in that all that is necessary to find that a contract is exempt is to demonstrate clearly it is the trading of an actual physical commodity and not trading in uniformly defined contracts.

The NGFA’s view is that a careful reading of these decisions, along with the decisions of the CFTC on cases concluded in late 2003, can lead to a much better understanding of a clear definition of cash forward contracts that are exempt from CFTC oversight. While we judge corrective legislation to be unnecessary at this time, some refinements of the existing statute could be in order if the regulatory process fails to achieve an adequate solution.

Producer Risk Management: Lower Government Support for Farmers May Create More Need for Risk Management Tools for Producers

As this subcommittee is keenly aware, government budget cuts and the negotiations coming up in the next round of the World Trade Organization could affect the level of government direct support to U.S. farmers. If this occurs, producers may find they have greater need for market-based risk management tools. Given this situation, it seems timely to at least review the market-based risk management tools now available to producers and to make note of regulatory barriers that are today restricting access for some producers.

Attached to this testimony is an appendix that provides an inventory of some market-based risk management tools, and offers some judgments as to why these tools may or may not be attractive to producers. Exchange based tools – futures and options markets – provide both a direct way for producers to manage price risk and the foundation for hedging a variety of cash contracts that are offered through merchandising companies. While a growing number of grain and oilseed producers are regularly utilizing exchange-based or cash contracting tools today, reductions in government programs that have traditionally protected against low price situations should create additional demand for such products.

As noted previously, modern cash contracts that are specifically tailored to producers’ need for risk management and flexibility can be facilitated further by the CFTC providing greater legal clarity on what terms and flexibility are legally acceptable. Also, while we are not advocating specific changes in agricultural trade options regulations, we do think it is appropriate that Congress be aware of stipulations in current regulations that restrict access to trade options and similar products.

Agricultural trade options (ATOs) were granted regulatory approval in April 1998, but the CFTC rules made the program very expensive and cumbersome to any entity that might have considered becoming licensed under the program. Subsequent refinements have encouraged little participation, and thus far, only one firm is even registered for that program.

While the CFTC's ATO regulations did little to provide new risk management tools to farmers in general, they did have other implications. The rule specifically exempts producers with \$10 million in net worth from any of the ATO regulations. Thus, any producer with a high net worth may have access to a range of potential new risk management tools that are unavailable to moderate-sized producers. While there is some logic to a high net worth being associated with market sophistication (and thus less need for CFTC oversight), given the potential value to producers, the level of restrictions on access to tools may be worthy of consideration.

Additionally, when the CFTC regulations were put into effect, they had a chilling effect on the agricultural swaps market. The exemption level for participating in all swaps markets (both enumerated agricultural commodities and other commodities) was originally set at a minimum of \$1 million in net worth. The CFTC's agricultural trade options regulations "clarified" that the minimum net worth for agricultural swaps going into the future was revised, beginning in 1998, to a minimum of \$10 million. This regulatory adjustment is known to have halted the use of certain agricultural swap contracts used to hedge price risks with some farm management companies.

Again, at this time, we do not make any specific recommendations on what is the right approach with the CFTC's regulation of trade options or swaps markets. But if, in fact, U.S. producers are confronting reductions in government support, there will be additional need for flexible risk management tools and, thus, a potential reason for reconsidering how either lack of legal clarity or existing regulations may restrict producer access to such tools.

Summary

To conclude, the NGFA strongly supports reauthorization of the CFTC. While we are not currently asking for major legislative changes, we suggest that a dialogue with the CFTC, and perhaps eventually with Congress, should begin to focus on three areas:

- 1) Futures exchange performance and oversight by the CFTC – and in particular, considering a potentially more flexible regulatory environment for U.S.-based exchanges with regard to agricultural contracts;
- 2) Greater legal clarity for cash grain contracts, with a view toward minimizing the litigation risk of companies working with producers on marketing strategies, and providing additional flexibility and marketing options for producers; and
- 3) Examining additional regulatory flexibility to aid producers in their risk management strategies in an era with potentially lower government support for production agriculture.

Mr. Chairman, we appreciate the opportunity to present our views on the CFTC and related risk management issues in agriculture. I would be happy to respond to any questions.

Appendix

Farmer Risk Management Tools: What's Available

The chart on the last two pages of this Appendix summarizes a number of the market-based risk management tools available to producers, including:

- 1) Exchange-based tools – futures, options;
- 2) Cash contracts (for crops) – fixed price, minimum price, and other;
- 3) Agricultural trade options.

A. Exchange-based tools. As the undisputed centerpiece of price discovery and price risk management in grain-based agriculture, exchange futures contracts remain the single most important tool and also provide the foundation for many other risk management tools. Virtually all cash contracts offered to grain farmers are designed so as to permit hedging the risk through exchange instruments. Thus, a high percentage of cash contracting activity establishes a price risk to the buyer that is ultimately “laid off” in futures markets.

Farmers may use futures markets directly to price products and hedge risk, and such tools have distinct advantages that are available only on regulated exchanges: 1) highly liquid markets allowing rapid adjustments in strategies, and are very cost-efficient; 2) guaranteed counter-party performance; 3) transparent pricing of the futures portion of cash price; and 4) mechanisms to price now or later and during periods of “carry” in the market, and to assure returns to farmers for grain storage activities. Exchange options require an up-front premium payment, but have the added feature of locking in an assured minimum futures price while giving the farmer an opportunity to participate in upward price swings. Options, unlike futures, do not require ongoing margining and the total cost is known in advance.

Why aren't exchange-based tools used by more farmers? With all the advantages that exchange-based products offer – many of which cannot be duplicated off-exchange – the question is often asked: Why don't more farmers use futures and options directly? The biggest disincentive to farmer use of futures has been the fact that past (and even some current) government programs contain features that give a free competitive alternative to exchange products. If government continues to deregulate commercial agriculture, there will be some growth in the direct use of futures markets by farmers, but there are reasons to expect the growth to be slow, at best: 1) The government loan rate continues as a free “put” option to the farmer; thus there is little need for the farmer to duplicate (and pay for) this position in the market unless prices are at a level moderately higher than the loan rate; 2) Futures markets only address the “futures” price portion of cash prices; basis levels (difference in central futures price and local cash price) remain a risk to be managed through the use of a separate tool (such as a basis contract); and 3) In the case of futures, the fact that daily “mark-to-market” occurs is beneficial in that the hedger knows his/her position every day, but the accompanying need to finance margin

requirements which can be annoying, or a potential financial risk to protect a hedge in a rapidly changing market. Possibly the most significant disadvantage of direct farmer use is that futures only address a portion (albeit the most significant portion) of price risk.

B. Cash Contracts. In the grain and feed industry, cash contracts that are statutorily exempt from CFTC regulation have traditionally been used to: market physical grain; establish the price (both regulatory futures and basis); and manage price risk within a single product. The defining feature of “exempt” cash contracts (in contrast with regulated futures) is that physical delivery is required and generally occurs. Fixed price cash contracts give the farmer the ability to establish a firm cash price weeks, months, or even years ahead. (The ability to establish forward prices would be greatly impeded, if not impossible, without the existence of the futures markets that offer price quotes and a liquid hedging vehicle for delivery periods months/years in advance.) Minimum price contracts permit the establishment of a minimum cash price but allow the farmer to participate in upward movements in market prices prior to delivery. The mini-max contract, establishes both a minimum and maximum price, thus the farmer knows in advance the best and worst cash price that he can receive for a given crop. Why would a farmer want to set a maximum price? By being willing to “cap” upside potential, the farmer can effectively reduce the premium cost to establish a price floor.¹ The basis contract allows the farmer to establish a fixed basis (difference in futures and local cash price), but permit the establishment of the reference futures price at a later date (presumably when futures are more favorable).

The hedge-to-arrive (HTA) contract is the mirror image of the basis contract: it permits the establishment of a futures contract reference price, and allows the farmer to set a basis level at a later date. Both the basis contract and the HTA are designed to offer “a la carte” marketing flexibility to the farmer – to be able to set futures and basis levels at separate times during the marketing year in an effort to “optimize” both components of the cash price. The delayed price (DP) contract is shown in the table to demonstrate that not all contracts have risk management features. The DP contract is used to transfer title and provides an alternative to storage. It contains no risk management features for farmers.

Why don't more farmers use forward cash contracts? Farmers use cash contracting more frequently than they directly use futures products. There are two principal reasons for this: 1) The ability to do business with someone “local” (the

¹ *The mini-max contract provides a good example of how various risk management services can be bundled to provide a fairly sophisticated and useful risk management tool, but one which is also readily understandable by the farmer. From the farmer's standpoint, a mini-max contract is straightforward: For a pre-established fee, the mini-max sets a fixed range of possible market prices for his/her crop. However, from the elevator's standpoint, this contract requires the bundling of the following services: 1) hedging futures risk which may entail three simultaneous transactions in futures and options markets [sell futures, buy a call (to establish minimum futures) and sell a call (to establish maximum futures)]; 2) management of cash basis risk; 3) management of financial risk (maintaining financing on the futures position); and 4) providing a physical delivery location for the commodity. Clearly, this bundling of services, and making the “risk profile” of the contract easy to understand by the farmer improves the likelihood that prudent risk management activities will be utilized.*

counter-party risk inherent in cash contracts, which is not present in futures, seems generally insufficient to offset this “local” market advantage); and 2) Cash contracts can provide a more complete risk management/marketing product through a bundling of services. (The most popular product – fixed price forward contract – addresses physical commodity marketing and establishes cash price – both futures and basis. It also includes financial services of margining the account and credit cost exposure.) Even so, farmers do not make as frequent use of forward cash contracts as might seem prudent. One likely reason for this is the requirement to deliver. In the event of crop failure, the farmer’s obligation to physically deliver remains in place. This is one of the reasons that many farmers that use cash forward contracts also may use crop insurance tools like MPCI or CRC to assure a minimum level of capacity to acquire physical bushels to be delivered.

C. Agricultural Trade Options: Agricultural trade options (ATOs) are not being widely offered today as only one firm has signed up to provide ATOs under CFTC regulations.

Agricultural trade options are defined here as contracts that establish the right, but not the obligation to deliver a physical commodity, and which can be cash settled at or prior to expiration. The primary feature differentiating an ATO from traditional cash contracts is that there is a clear option for not executing on delivery of the commodity. In agriculture, given the nature of weather risk, the right to “walk away” from delivery for a defined price (the option premium) could be beneficial and could encourage earlier season and more aggressive forward contracting by producers even when the exact size of the producer’s crop is unknown.

Summary of Major Risk Management Tools for Grain/Oilseed Producers

	<u>Risks Being Managed</u>	<u>Advantages</u>	<u>Disadvantages</u>
<u>I. Exchange tools</u>			
Exchange Futures	– Price Risk: (futures portion only)	– Liquidity – Daily mark to market – Guaranteed counterparty performance – Central price discovery – Allows assured market earnings for storage	– Addresses only futures prices – Margin calls in rapidly changing market (potential financing risk)
Exchange Put Option (set min futures prices)	– Price Risk: (futures price only; limits downside risk)	– liquidity – ability to cash settle; access to additional time value upon liquidation – no counterparty	– addresses only futures price risk
<u>II. Cash Contracts</u>			
Fixed Cash Forward	– Price Risk: futures and basis risk	– Ability to lock in firm cash price (futures and basis)	– Risk of unexpected large yield loss (required to deliver whether physically produced or not) – Perceived opportunity cost (contracted too early in uptrading market) – Counterparty risk
Minimum Price Contract	– Price risk; futures and basis risk – Limited yield risk management	– Sets minimum price but seller benefits from market rallies	– Counterparty risk – Risk of unexpected large yield loss
Mini-max	– Price risk; futures and basis	– Sets minimum and maximum price	– May limit upside market prices
Basis Contract	– basis risk only	– Permits establishing basis level and futures price at different times (flexibility to attempt to optimize total cash price)	– Leaves the most sizable portion of price risk (futures) open to declines – Counterparty risk

	<u>Risks Being Managed</u>	<u>Advantages</u>	<u>Disadvantages</u>
Hedge-to-Arrive (HTA)	<ul style="list-style-type: none"> - Futures (virtually equivalent outcome to short futures position) 	<ul style="list-style-type: none"> - Permits establishment of futures & basis at different times - No margin calls 	<ul style="list-style-type: none"> - Counterparty risk - Risk of unexpected yield loss
Delayed Price (DP)	<ul style="list-style-type: none"> - Manages no risks 	<ul style="list-style-type: none"> - Logistical tool that provides alternative to storage 	<ul style="list-style-type: none"> - Counterparty risk
III. <u>Agricultural Trade Options (ATOs)</u>	<ul style="list-style-type: none"> - Price (futures and basis) - Yield - Logistical 	<ul style="list-style-type: none"> - Assists the producer in managing yield risk 	<ul style="list-style-type: none"> - Counterparty risk - Regulatory burden on ATOM - Smaller farmers may be unable to participate (\$10 million net worth to be exempt)

COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

STATEMENT OF JOHN M. DAMGARD, PRESIDENT
FUTURES INDUSTRY ASSOCIATION

MARCH 9, 2005

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

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

- Authorize the Commission to develop a regulatory program for markets that would be "tailored to match the degree and manner of regulation to the varying nature of the products traded thereon, and to the sophistication of the customer;"
- Remove the 20-year prohibition on futures on individual securities and narrow-based securities index contracts and, in another radical departure, provided for the joint regulation of these products by the Commission and the Securities and Exchange Commission; and
- Assure legal certainty for over-the-counter derivatives.

The CFMA signaled a dramatic, new approach to the regulation of the derivatives markets and, as such, placed enormous demands on the Commission and its staff as they developed the regulations necessary to implement its myriad provisions. They have met the challenge, and we appreciate their efforts. While FIA and the CFTC do not see eye to eye on every issue, we believe the CFTC is an excellent federal agency that discharges its

statutory obligations in an efficient and effective manner. The CFTC's past and present leadership is to be commended for this record. The CFTC deserves to be reauthorized.

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

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

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

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

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

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

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

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

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

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

At that point, the CFTC has the authority to take the serious step of rescinding the exchange's self-certified rule change and insisting that the rule be resubmitted for pre-approval. The CFTC, naturally and practically, is reluctant to interfere with the judgment

of an exchange or designated clearing organization. But the CFTC has no process in place to solicit public input on self-certified rules and, therefore, has no way to assess formally the potential competitive impact of an exchange's rule change.¹

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

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

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

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

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

SRO Governance. FIA supports the important role that the exchanges, clearing organizations and the National Futures Association (NFA) perform as self-regulatory organizations (SROs) and designated self-regulatory organizations (DSROs). Given their strong market knowledge and close proximity to the trading markets, they provide the best vantage point for addressing many of the futures markets' oversight functions. However, to be fully effective, there must be an increased degree of public confidence in the integrity and objectivity of SROs.

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

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

- Core principle 15 requires exchanges to “establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest;” and
- Core principle 18 requires exchanges “to avoid (1) adopting any rule or taking any action that results in any unreasonable restraint of trade, or (2) imposing any material anticompetitive burden on trading,” “unless appropriate to achieve the purposes of the Act”.³

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

Among other requirements, section 5(b) of the Act, which sets out the criteria for designation as a contract market, imposes on exchanges the obligation to adopt and enforce rules (1) to ensure fair and equitable trading, (2) to ensure the financial integrity

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

of transactions entered into by or through the facilities of the exchange, (3) to prevent market manipulation, and (4) to discipline members or market participants that violate such rules.

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

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

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

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

We want to be clear that FIA is not seeking a return to the rule review procedures that were in place prior to the enactment of the CFMA. Nonetheless, it may be

appropriate to identify a select category of rules, primarily those relating to clearing and certain trading rules, on which market participants should be afforded the right to comment, either at the exchange level or at the CFTC.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In recent years, we have witnessed a trend to fraudulent operations with a "commodity" theme. It is increasingly apparent that the Commission, with its limited budget and resources cannot possibly put a stop to these frauds if it is the only cop on the beat.⁵

⁵ Further clarifying the limited scope of the Commission's jurisdiction, Congress also amended the definition of a commodity trading advisor. Prior to the 1982 Act, a commodity trading advisor was broadly

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

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

defined to include any person who was engaged in the business of providing advice "as to the value of commodities," including cash and forward market transactions. As amended in the 1982 Act, a commodity trading advisor is defined as any person providing advice "as to the value of or advisability of trading in any contract for futures delivery made on or subject to the rules of any contract market, any commodity option authorized under section 4c, or any leverage contract authorized under section 19 of this Act." That is, a person is required to be registered as a commodity trading advisor only if that person is providing advice with respect to transactions that fall within the Commission's exclusive jurisdiction.

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ATTACHMENT TO TESTIMONY OF JOHN M. DAMGARD

MARCH 9, 2005

HEARING BEFORE THE GENERAL FARM COMMODITIES AND RISK
MANAGEMENT SUBCOMMITTEE

HOUSE COMMITTEE ON AGRICULTURE



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September 30, 2004

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

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

Dear Ms. Webb:

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

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

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

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

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

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Introduction

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

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

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

Recommendations

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

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

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

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

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

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

1. Independence of Regulatory Functions

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

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

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

⁸ Position Paper at 1.

⁹ Position Paper at 1.

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

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

FIA believes that, consistent with Core Principles 14-16¹⁰, the Commission should use its authority to require SROs to implement the reforms outlined above and to ensure continued compliance. These changes would ensure greater independence of the board generally and the key committee described above to screen out inappropriate appearances of bias or conflicts. As a consequence, the changes would help SROs achieve the goal of greater independence of the regulatory function.¹¹

2. Separation of Marketplace and Regulatory Functions

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

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

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

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

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

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

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

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

Rulemaking

The rules¹³ that an SRO adopts and the manner in which it enforces them are critical to complying with the core principles and, as important, to properly meeting its responsibilities as an SRO. Among other requirements, section 5(b) of the Act, which sets out the criteria for designation as a contract market, imposes on DCMs the obligation to adopt and enforce rules (1) to ensure fair and equitable trading, (2) to ensure the financial integrity of transactions entered into by or through the facilities of the DCM, (3) to prevent market manipulation, and (4) to discipline members or market participants that violate such rules. To both enhance the quality of SRO rulemaking and engender confidence in the SRO rulemaking process generally, the procedures by which a DCM adopts and enforces these rules should be transparent and should assure that members and other market participants, not just one constituency, have an opportunity to express their views and otherwise participate in the process.¹⁴

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

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

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

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Neither the Act nor the Commission's rules prescribe the procedures that an SRO should follow in adopting rules. Nonetheless, we believe the essential elements of these procedures are implied in Part 40 of the Commission's rules. In particular, Commission Rules 40.5(a)(1)(v) (voluntary submission of rules for review and approval) and 40.6(a)(3)(iv) (self-certification of rules) each require a DCM to "describe any substantive opposing views expressed with respect to the proposed rule that were not incorporated into the proposed rule."¹⁵ Further, Commission Rule 40.5(a)(1)(iv) requires an SRO, in submitting a rule for approval, to include in its submission, an explanation of the operation, purpose and effect of the rule, including, as applicable, a description of the anticipated benefits, any potential anticompetitive effects, and how the rule fits into the framework of self-regulation.¹⁶ We submit that an SRO cannot comply with the provisions of these rules—and the Commission cannot properly determine whether the SRO's rules violate applicable core principles, including the requirement that the SRO endeavor to avoid adopting any rule that results in an unreasonable restraint of trade or imposes any material anticompetitive burden on trading¹⁷—unless the SRO's rulemaking procedures are designed to solicit input from members and affected market participants on significant rule proposals.

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

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

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

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

¹⁷ Section 5(d)(18) of the Act.

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

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

Disciplinary Process

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

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

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

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

Ms. Jean A. Webb
September 30, 2004
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independent panelists. Furthermore, including panelists from the same industry segment as the person or entity charged can help guard against the possibility that panel members may not know enough about the behavior to judge it properly or worse, may want to punish a competitor from an alternative market.

However, FIA recognizes that including people from the same industry segment creates the risk that a panel may impose sanctions that are too light — protecting a friend; hoping that the competitor will remember the favor if roles are reversed in the future — or conversely, may impose sanctions that are too harsh — punishing a direct competitor. To address these concerns, FIA recommends the following reforms: (i) the independent committee of the board should appoint disciplinary panels; (ii) as noted in the Position Paper²⁰, disciplinary panels should be made up of a majority of knowledgeable independent panelists; (iii) industry members who represent a fair cross section of the industry should augment the panels²¹; (iv) at the request of non-industry panelists, the disciplinary panel should be able to seek the views of independent experts; and (v) aggrieved persons or entities should have the right to appeal to the full committee of independent directors or to a panel comprised solely of such independent committee members.

4. Preventing Unauthorized Disclosure of Confidential Information

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

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

²⁰ Position Paper at II.

²¹ See discussion below concerning confidentiality of information.

²² As discussed above, we also recommend that the business and marketing staffs of an SRO be functionally separate from the regulatory and compliance staffs.

²³ In our June 18, 2004 letter to the Commission on the proposed revisions to the Joint Audit Agreement, we noted that the Commission had "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-

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FIA recognizes that SROs have generally adopted codes of conduct, which include a provision prohibiting any person involved in the SRO process from disclosing or taking commercial advantage of confidential proprietary information obtained in the course of SRO activities. All such codes should be transparent and publicly available. Further, SROs should require their board members, staff, and outside consultants to sign such codes before undertaking SRO responsibilities.²⁴

Conclusion

FIA appreciates this opportunity to comment on SRO governance. If the Commission has any questions concerning the comments in this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,



John M. Damgard
President

cc: Honorable Sharon Brown-Hruska, Acting Chairman
Honorable Walter L. Lukken, Commissioner

Division of Market Oversight
Richard A. Shilts, Acting Director
Steven B. Braverman, Deputy Director
Rachel Berdansky, Special Counsel

regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures." FIA endorsed the Commission's request and urged the Commission to make any information submitted by the SROs publicly available. To date, neither the SROs nor the Commission has released any information in this regard.

²⁴ The Position Paper recommends that "the FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions." The Position Paper explains that "given the number of exchanges that have SRO and DSRO responsibility, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges." Position Paper at IV. We suggest that the development and review of codes of conduct for confidentiality and other purposes could be the first such project.

**CFTC Study of Self-Regulation
Position Paper of the FIA
June 8, 2004**

Summary

FIA supports the important role that exchanges and clearing houses perform as self-regulatory organizations (SRO) and designated self-regulatory organizations (DSRO). Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure.

FIA believes there is merit in the existing structure worth preserving and that more extreme alternatives are not desirable and are less efficient. Nevertheless, the existing structure can be improved through greater transparency and oversight that will minimize any potential conflict of interests. To be fully effective, there must be an increased degree of confidence in the integrity and objectivity of the SRO. We believe that specific modifications to the SRO structure can increase its overall efficiency and effectiveness. In addition, a clear delineation of the role and responsibility of the CFTC in proactively overseeing these SRO functions will enhance SRO performance and public confidence in the SRO structure.

The CFTC has been progressing with its review of the effectiveness of self-regulation in the futures industry. To facilitate this review, FIA has prepared this Position Paper to highlight key areas of concern in the hope that the CFTC will recognize the merits of these positions and take them into account in its assessment and recommendations for change in SRO responsibilities. In this regard, there are four broad issues that FIA recommends the CFTC address in its SRO Study. For each of these issues, FIA provides recommendations for specific changes to current SRO structures.

I. **Potential Conflict of Interests - There should be a division between the business and SRO/DSRO functions of exchanges and clearing houses.**

The exchanges provide a public good and public service through price discovery and a well-defined marketplace yet there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses. This problem potentially is exacerbated by demutualization and the move to for-profit structures. FIA recognizes that shareholders of for-profit structures are motivated in the long run to ensure market integrity and their failure to do so should ultimately reduce revenues and profit; however, there may be times when specific events will override the longer-term objectives of the exchange.

Recent legislative and regulatory actions against public companies, including the enactment of the Sarbanes-Oxley Act, suggests that without specific safeguards for-profit companies may not always act in the public interest. The possibility that exchanges or clearing houses can abuse their SRO responsibilities to the detriment of market participants and the public good cannot be dismissed. FIA believes that a more formal separation between the business and SRO functions of exchanges and clearing houses is essential to overall marketplace integrity. In that regard, we have the following recommendations.

- **A Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities.**

FIA recommends that each exchange/clearing house have such a Board Committee of independent, non-industry directors and that the Committee have the responsibility to oversee the SRO/DSRO budget, hire and fire compliance staff, ensure adequate staff and resources, review cases, audit SRO/DSRO performance and otherwise oversee all aspects of the SRO/DSRO function. In addition, it is absolutely critical that there be a definition of “Independent” that avoids any appearance of bias, conflict or any lack of independence. FIA is not convinced that current exchange and others’ definitions of “independent” are adequate in these regards. In addition to being independent, these directors should not be currently active in the industry.

- **The Board Committee should be responsible to the CFTC for its oversight of the SRO/DSRO functions**

Like independent audit committees of public company boards under Sarbanes-Oxley, this Board Committee should have real accountability. Its activities, its responsibility for the budget and the audit all should be reviewed by the CFTC at least annually.

- **There should be a more formal separation between the business and compliance/surveillance staffs of exchanges and clearing houses.**

Compliance and surveillance staff should report to the Board Committee. They should not be involved in the business activities of the exchange or clearing houses and should not be in a supervisory chain that includes managers on the business side of the exchange or clearinghouse. To the extent the SRO function is contracted out, it still should not report to business managers. Any other result creates conflicts of interest and undermines the recommended separation and the role of the independent Board Committee.

- II. **Appearance of Bias – A majority of the members judging proceedings should be disinterested parties.**

FIA recognizes that its concerns about SRO fairness will be reduced with the adoption of its recommendation of Board Committees of independent, non-industry directors overseeing SRO/DSRO functions. However, additional measures must be taken to address

related issues of fairness and confidentiality and to ensure SRO decision-makers will be independent of business pressures. In particular FIA is concerned that disciplinary panels dominated by peers judging peers has an inherent appearance of bias. Equally, disciplinary panels consisting of only one category of market participant can be seen as unfair especially from the viewpoint of other categories of market participants subject to the panels' disciplinary review. Market participants are entitled to a fair hearing. In this regard, FIA has the following recommendations.

- **A majority of the members of disciplinary panels should be made up of knowledgeable independent panelists.**

While FIA respects the experience and judgment of interested panel members, an appearance of fairness and the avoidance of bias are enhanced when a majority of disciplinary panel members are independent. Consideration should be given to permitting parties subject to discipline to request panels made up entirely of independent members.

- **Interested parties should not review the records of disciplinary proceedings and settlements.**

Currently, exchange committees and in some cases the entire Board of Directors reviews disciplinary records and settlements. These records reveal confidential information that should not be shared with competitors or other interested parties. The use of independent committees and the Board Committee of independent directors should address this problem.

III. **Enhanced Transparency – The CFTC should establish clear standards for DSROs and the allocation of firms among them.**

The efficiencies of the DSRO approach are widely recognized. At the same time, providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function. The CFTC should establish clear standards for qualification as a DSRO including a process to approve new providers wishing to perform financial compliance audits. Each of these providers should be subject to periodic CFTC review of their DSRO functions. This oversight should include detailed review of DSRO audits. A mechanism should be established to make the choice of DSRO cost neutral to exchange members. Subject to CFTC adopted standards, a member firm should be able to change its DSRO within the narrow band of CFTC pre-approved providers.

IV. **Sound Practices – The FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions.**

Given the number of exchanges that have SRO and DSRO responsibilities, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges. These sound practices should follow the model of core principles in the

Commodity Futures Modernization Act. In particular, directors who serve on the independent Board Committee with oversight responsibilities over SRO and DSRO activities should be trained to apply these industry-wide sound practices.

Conclusion

FIA believes that this is an ideal opportunity to improve a process that has largely been successful but may have certain conflicts and biases. FIA's hope in raising these issues and making these recommendations is to promote a dialogue that will lead to a fairer and more efficient SRO structure for the futures industry.



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June 18, 2004

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

Re: Futures Market Self-Regulation, 69 *Fed.Reg.* 19166 (April 12, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the proposed revisions to the Joint Audit Agreement to be entered into among the several self-regulatory organizations ("Proposed Agreement").²⁵ FIA supports the important role that exchanges and the National Futures Association ("NFA") perform as self-regulatory organizations ("SROs") and designated self-regulatory organizations ("DSROs").²⁶ Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, as explained in detail below, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure that would be ratified in the Proposed Agreement.

Before addressing specific aspects of the Proposed Agreement, however, FIA notes that the Commission recently issued a *Federal Register* release requesting comment on a series of questions relating to the structure and governance of self-regulatory organizations. 69 *Fed.Reg.* 32326 (June 9, 2004). The latter release, which was issued in connection with the Commission's review of SROs, requests comment on such matters as the composition of boards of directors, issues arising from different forms of ownership, regulatory structure,

²⁵ FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

²⁶ Pursuant to Commission rule 1.3(ee), an SRO is defined as a designated contract market or a registered futures association. A DSRO is defined under Commission rule 1.3(ff) as an SRO assigned responsibility for monitoring and auditing an FCM in accordance with a plan approved under Commission rule 1.52. Significantly, designated clearing organizations are not self-regulatory organizations under the Commission's rules.

including the structure of disciplinary committees, and potential conflicts of interest generally. FIA recently filed with the Commission a position paper outlining several broad areas of concern in this area and will be preparing a more detailed response to this release.²⁷

In our view, the Commission's review of the Proposed Agreement cannot be considered separately from the Commission's more general review of SROs. Certainly, FIA's comments below might well change depending on the Commission's response to our broader concerns. Therefore, we recommend that the Commission defer any decision with respect to the Proposed Agreement until its SRO study is complete.

A Changed Industry

The derivatives industry has undergone significant change in the twenty years since the original Joint Audit Agreement was entered into in 1984 and, in particular, in the years following enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"). Legal uncertainty surrounding over-the-counter ("OTC") derivatives transactions among qualified eligible participants has been resolved, and a burgeoning OTC market in swaps and other derivatives instruments both competes with and complements the exchange traded markets.²⁸ Many FIA member firms, either directly or through affiliates, are active participants in the OTC derivatives markets. Concurrently, the clearing divisions of the Chicago Mercantile Exchange ("CME") and the New York Mercantile Exchange ("Nymex") both offer to provide clearing facilities for OTC derivatives.

Moreover, exchanges have entered into direct competition with each other. BrokerTec Futures Exchange and, more recently, the U.S. Futures Exchange ("USFE"), an indirect subsidiary of Eurex Frankfurt AG, have challenged the Chicago Board of Trade's ("CBT's") dominance in futures on U.S. Treasury instruments, leading the CBT to counter by offering futures on the German Bund, Bobl and Schatz.²⁹ Meanwhile, Euronext.Liffe recently began offering futures on Eurodollars, in direct competition with the CME.

Finally, not all clearing organizations are as tied to futures exchanges as they once were. The CBT has terminated its relationship with The Clearing Corporation and has been clearing transactions through the CME since late 2003.³⁰ The Clearing Corporation now provides

²⁷ Letter to James Newsome, Chairman, from John M. Damgard, President, FIA, dated June 8, 2004.

²⁸ The International Swaps and Derivatives Association ("ISDA") estimates that, as of December 31, 2003: (1) the notional principal outstanding volume of interest rate derivatives, which include interest rate swaps and options and cross-currency swaps, was \$142.31 trillion; (2) the notional value of outstanding credit derivatives, including credit default swaps, baskets and portfolio transactions was \$3.58 trillion; and the outstanding notional value of equity derivatives, consisting of equity swaps, options, and forwards, was \$3.44 trillion.

²⁹ As a result of its purchase of BrokerTec Futures Exchange, several of the larger FCMs own a significant interest in USFE.

³⁰ The Clearing Corporation, of course, has always been an independent legal entity.

clearing services for USFE and other exchanges. In addition, the London Clearing House has been approved as a designated clearing organization (“DCO”), but does not yet provide clearing services for any designated contract market (“DCM”). Although not represented on the Joint Audit Committee (“JAC”), independent clearing organizations have a clear and undeniable interest in the financial integrity of member FCMs.³¹

As the above summary indicates, the derivatives industry is anything but static. More important, the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement. Further, we submit that the Proposed Agreement should provide the flexibility necessary to accommodate the inevitable changes the industry will experience in the years ahead.

Voting Eligibility

Paragraph 3 of the Proposed Agreement provides that “[o]nly those Parties which were members of the JAC prior to the year 2000 or which conduct their own auditing activities as a DSRO (rather than subcontracting such responsibilities) shall be eligible to vote.” Neither the Proposed Agreement nor the *Federal Register* release requesting comment explains the reasons underlying this provision. On its face, it appears to have no rational basis.

What regulatory purpose is served by granting voting privileges to AMEX Commodities Exchange and the Philadelphia Board of Trade, neither of which currently list products for trading, while denying voting privileges to USFE? Certainly, the distinction cannot be based on the decision of USFE to subcontract certain of its self-regulatory responsibilities to NFA. A review of the Commission’s *Selected FCM Financial Data* as of May 31, 2004, indicates that, with a few exceptions, DSRO responsibilities are performed by only three self-regulatory organizations—CBT, CME and NFA.³² Without further explanation, the provisions of paragraph 3 relating to voting eligibility appear to have no purpose but to assure the continued dominance of the “old exchanges” over the “new exchanges.”

Under the Commodity Exchange Act (“Act”), all DCMs have self-regulatory obligations that they are required to meet. Further, although the Act clearly contemplates that DCMs may delegate these obligations to a registered futures association, such as NFA, or another

³¹ As noted in footnote 2 above, DCOs are not self-regulatory organizations under the Commission’s rules. Nonetheless, DCOs have an obvious interest in the financial integrity of their member FCMs. Therefore, procedures should be developed to assure that DSROs provide independent DCOs the same access to financial and other relevant information obtained by a DSRO with respect to a member FCM as the DSRO now makes available to DCOs that are divisions of a DCM. In addition, consideration should be given to inviting independent clearing organizations to participate, if not vote, in meetings of the JAC.

³² Of the 178 registered FCMs: NFA is the DSRO for 97 FCMs; the CBT is the DSRO for 40 FCMs; the CME is the DSRO for 29 FCMs; Nymex is the DSRO for 10 FCMs; and the Kansas City Board of Trade and New York Board of Trade are the DSRO for one FCM each.

registered entity, the Act also provides that that DCM “shall remain responsible for carrying out” these obligations.³³ As long as a DCM has statutory self-regulatory obligations that it is required to meet and, consequently, may be held responsible for the manner in which a DSRO performs these obligations on its behalf, FIA believes that each DCM should have an equal voice in matters that become before the JAC.³⁴

Allocation of Firms Among DSROs

As noted earlier, the CBT, CME and NFA serve as the DSROs for essentially all registered FCMs. Further, either the CBT or the CME is the DSRO for all but two of the twenty largest FCMs by amount of segregated funds held.³⁵ FIA is not concerned that these three entities perform the majority of DSRO activities on behalf of other DCMs. To the contrary, particularly in the area of financial audits, we believe that the expertise demanded of audit staff effectively requires that these responsibilities be exercised by a small number of qualified SROs. Nonetheless, two aspects of the Proposed Agreement cause concern.

First, the Proposed Agreement provides no means by which an FCM may participate in the selection of its DSRO. In addition, once assigned to a DSRO, an FCM may not be reassigned, except with the consent of that DSRO. As we discussed at the outset of this letter, exchanges and their FCM members are increasingly engaged in activities that appear to compete with each other. Consequently, an FCM may find that its activities are being audited by an exchange that is, or at least appears to be, its competitor. In these circumstances, and in order to avoid even an appearance of a conflict of interest, an FCM should have the ability to change its DSRO.³⁶

³³ Section 5c(b) of the Act.

³⁴ Paragraph 3 of the Proposed Agreement also provides:

If two or more Parties become commonly owned through a merger or acquisition, the surviving Party is entitled to one representative on the JAC; provided, however, that any Party which maintains a separate legal entity after an acquisition, will retain their representative on the JAC.

FIA agrees that, if two or more DCMs become commonly owned, they should be entitled only to one representative and one vote on the JAC in all instances. The fact that a DCM is maintained as a separate legal entity following an acquisition should not entitle that entity to representation or a vote.

³⁵ Based on the Commission’s *Selected FCM Financial Data* as of May 31, 2004, these twenty firms hold in excess of 85 percent of all customer segregated funds. Of these firms, the CBT is the DSRO for 12, the CME is the DSRO for six and Nymex is the DSRO for two.

³⁶ We want to be clear that we are not asserting that any DSRO has acted, or would act, in a way that would constitute a conflict of interest. Nor would we anticipate any rush by FCMs to change their DSRO. To the contrary, in our discussions with FIA member firms, they are by and large satisfied with the DSRO to which they have been assigned. Nonetheless, as we noted in our June 8, 2004 position paper on self-regulation, “providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function.”

We have considered various means by which an FCM could be permitted to change its DSRO and suggest that an FCM should be able to change its DSRO on a periodic basis, *e.g.*, every five years.³⁷ The FCM could request this change for any or no reason. Although an FCM could participate in the selection of its DSRO, the FCM would not have the unilateral right to choose the DSRO that would assume responsibility for the firm. Rather, the DSRO would be chosen from among those SROs that the Commission has determined meets clear and objective standards. Any procedure should assure and prevent any appearance that the FCM was engaging in regulatory arbitrage among DSROs.³⁸ Separately, FIA believes the Commission should establish procedures in rule 1.52 by which an FCM may petition the Commission to request a change in the FCM's DSRO in the unlikely event that the DSRO has engaged in egregious misconduct with respect to the FCM.

Second, we believe that the exchanges should not have the unquestioned right of first refusal with respect to the allocation of DSRO responsibilities among exchange member firms. As discussed above, in light of the potential appearance of conflict of interests between an FCM and its DSRO, FIA believes that procedures should be considered to permit NFA or another non-exchange entity to serve as an FCM's DSRO, *provided* that entity meets Commission approved standards.

Confidentiality

The information that DSROs obtain in the course of their examinations of member firms and the records they prepare obviously contain confidential proprietary and business information that an FCM would not otherwise disclose. FIA is concerned that the confidentiality provisions set forth in paragraph 8 of the Proposed Agreement do not provide sufficient assurance that such information will not be shared with other divisions of the DSRO or with other SROs except for appropriate cause. Since FCMs are not parties to the Proposed Agreement and otherwise appear to have no cause of action against an SRO that may improperly disclose confidential information, it is particularly important that the responsibilities of SROs in this regard be clearly circumscribed.³⁹

In a press release dated February 6, 2004, the Commission announced that it has "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-

³⁷ No FCM, however, would be required to change its DSRO under this procedure.

³⁸ As noted in our June 8 position paper, FIA believes that a mechanism should be established to make the choice of DSRO cost neutral to exchange members.

³⁹ Again, FIA is not asserting that the audit staffs of any exchange or other SRO have inappropriately shared otherwise confidential business information.

regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures.”⁴⁰

Consistent with the Commission’s recommendations, FIA respectfully submits that the Proposed Agreement governing confidentiality of FCM proprietary and business information should be revised to describe specifically the limitations on the use of such information. In addition, FIA believes the Commission should consider adopting a rule requiring the confidential treatment of all proprietary and confidential information collected during an examination. Such a rule would assure that violations of FCM confidentiality would be subject to appropriate penalty.

Commission Review

In light of the constant change that is the hallmark of the derivatives industry and the potential conflicts of interest that are inherent in any self-regulatory structure, FIA encourages the Commission to play a more active role in overseeing the activities of the Joint Audit Committee.

Conclusion

FIA appreciates the opportunity to submit these comments on the Proposed Agreement. If you have any questions concerning this letter, please contact Barbara Wierzynski, FIA’s General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable James E. Newsome, Chairman
Honorable Walter L. Lukken, Commissioner
Honorable Sharon Brown-Hruska, Commissioner

Division of Clearing and Intermediary Oversight
James L. Carley, Director
Thomas J. Smith, Associate Director

⁴⁰ FIA supports the Commission’s request that SROs examine their policies and procedures designed to protect the confidentiality of member information and make these policies and procedures public. FIA is not aware that any SRO has responded to the Commission to date. We recommend that this information be made publicly available as soon as possible in order to afford FIA and others an opportunity to submit comments in response to the Commission’s June 9, 2004 *Federal Register* release.

**Testimony of Martin Doyle, President, OneChicago LLC
Hearing on CFTC Reauthorization, March 9, 2005
Before the House Agriculture Committee
Subcommittee on General Farm Commodities
and Risk Management**

Mr. Chairman and members of the Subcommittee, I am Martin Doyle, President of OneChicago, LLC, the U.S. exchange for single stock futures and other security futures products. On behalf of OneChicago, our Chairman Peter F. Borish, and our joint-venture owners, we want to thank you for extending an invitation to us to present our views. I look forward to answering any and all questions you may have regarding single stock futures and OneChicago.

What is OneChicago?

OneChicago is a true product of the Commodity Futures Modernization Act of 2000. A main purpose of the CFMA was to “provide a statutory and regulatory framework for allowing the trading of futures on securities” by ending the almost 20 year statutory ban on U.S. trading in those instruments. It is no exaggeration to say that without this Subcommittee’s work on the CFMA, OneChicago would not be here. We thank you and your predecessors for your work on that ground-breaking legislation.

By law, security futures are futures contracts on an individual security or a narrow-based securities index. Congress understood that these new forms of futures contracts could be attractive to mutual funds, hedge funds, pension funds, financial institutions and other investors who are either trying to manage their investment risk or assume a market view. Offering these products in an exchange-trading environment was thought to promote price transparency and liquidity in these products within a safe and financially-secure clearing system.

OneChicago is a joint venture of the Chicago Board Options Exchange Incorporated® (CBOE®), Chicago Mercantile Exchange Inc. (CME) and the Chicago Board of Trade (CBOT®). OneChicago trades only single stock futures and other security futures products. All OneChicago products are electronically traded on the CBOEdirect® match engine and accessible through the CBOEdirect and GLOBEX® platforms. All security futures can be traded through either a securities or a futures account.

OneChicago is a contract market designated by the Commodity Futures Trading Commission and is a notice registered securities exchange with the Securities and Exchange Commission. OneChicago is the only U.S. market in single stock futures and security futures products. And OneChicago offers a market only in those new investment products.

OneChicago’s Start and Challenges.

OneChicago began trading on November 8, 2002, with 34 listings or futures on 34 stocks. Today, OneChicago lists 136 single stock futures contracts. All of the underlying stocks

are included in the S&P 500, ranging from Apple and Boeing to Starbucks and Wal-Mart. We also offer futures contracts on seven narrow-based stock indexes¹ and one exchange traded fund (ETF) known as DIAMONDS.

Our progress has been steady. As with any new trading product, it has been a challenge to develop market momentum and liquidity. In 2003, our first full year, OneChicago traded 1,619,194 security futures contracts, which equates to an average daily volume (ADV) of 6,425 contracts. Our 2004 volume increased to 1,922,726 contracts for an ADV of 7,630.² While this does represent a 19% increase, our volumes and percentage gains pale when compared to those at overseas security futures exchanges. This situation is distressing to us, as we believe it will be to the members of this Subcommittee, especially since we know that one of the principal reasons Congress chartered single stock futures in the CFMA was to make sure U.S. markets could meet our foreign competition.

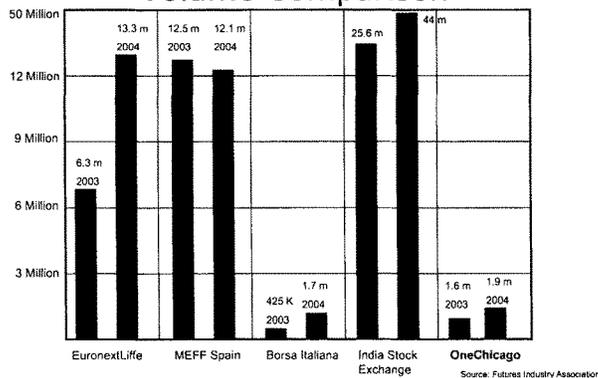
When Congress lifted the ban and authorized security futures products in 2000, security futures already had begun to be traded in foreign markets. We know this Subcommittee and others in Congress did not want to see U.S. markets fall behind those in England, Italy, Spain or India, among others. The U.S. is the home of financial innovation, the birthplace of financial futures trading. Having to play catch-up with foreign markets was not a desirable option for any one. Congress ended the ban and allowed us to offer security futures products in an effort to avoid having the U.S. markets trail those in other countries.

But look at the numbers from our foreign competition. Even accounting for their head start, their volume and growth are out-pacing us. Consider the following chart.

¹ We list futures on the Dow Jones MicroSector Indexes, which are narrow-based indexes of five highly correlated stocks within the same industry sector. OneChicago has made a strategic decision to delist these narrow based indexes following the March expiration to concentrate on single stock futures.

² Our open interest at OneChicago has consistently held between 150,000 and 300,000 contracts, depending upon where we are in the contract expiration cycle. As of Monday, March 7, 2005, we had 203,536 contracts in open interest, demonstrating to us that the product is indeed viable and that the financial community is interested in trading single stock futures. We have attached to this testimony a list of all of the contracts trading on OneChicago and our trading volume for the month of February, 2005.

Single Stock Futures Volume Comparison



As the chart shows, at the London based Euronext.Liffe exchange, 2004 single stock futures volume was up 114% over 2003 volume, with a total to 13.5 million contracts traded. And at Italy's Borsa Italiana, single stock futures volume rose more than 250% last year as it traded over 1.7 million contracts. At the Stock Exchange of India, 2004 single stock futures volume was up 72% to 44 million contracts, according to figures compiled by the Futures Industry Association. And finally, even at Spain's MEFF exchange, where single stock futures volume was basically flat, they were still able to trade 12.1 million contracts. As you can see, it is clear that at this time the security futures industry in the United States has not caught up with our competitors on foreign exchanges.

There are many potential explanations for these comparative volume and growth rates. But the fact remains that one area of difficulty that has compromised our ability to grow this market stems from certain aspects of the CFMA itself, and its implementation.

For that reason, our message to this Subcommittee is simple: "we need some help." We are starting a new business and offering a new product under special regulatory restrictions imposed by both the Commodity Futures Trading Commission and Securities and Exchange Commission. We have made a solid start. Like any new venture, there are things we have done well and things we could have done better. We have control over those business and operational issues. But we need your help with some of the regulatory and statutory hurdles.

We understand the reasons we are operating under some of these special constraints -- any new product involves many "unknowns" and is often greeted with regulatory caution and a list of well-intentioned "what ifs." OneChicago has no quarrel with the bulk of the regulatory framework or the good faith efforts of the CFTC and the SEC. While in a perfect world we would prefer a single regulator, we try to be realists. In a number of critical areas,

however, based on our now two-year experience with this new product, we believe the regulations and laws governing U.S. security futures markets could use some adjustment so that we may compete more effectively with foreign markets.

Some will counsel patience and state correctly that gaining market acceptance for any new product is a substantial challenge. In our case, that challenge has been magnified by the following phenomenon: before OneChicago's creation, U.S. financial market participants were using other available products to perform many of the same economic functions that security futures perform. Through these other products -- whether synthetic futures formed through combination of exchange-listed stock options, over-the-counter options or equity swaps and other forms of derivatives -- U.S. investors were finding ways to hedge stock price risks under existing regulatory rules. To attract those investors to our market, therefore, OneChicago had to convince our potential customers that there were advantages to shifting their business practices to trading a new product on a new exchange.

But OneChicago's new product also came with new regulatory strings attached. The CFMA treated single stock futures and security futures as a hybrid, part security, part option, part futures contract. Trading OneChicago's new products therefore required market participants to become comfortable and compliant with new regulatory rules and other legal requirements. Although many people worked very hard to try to smooth over the rough edges of this hybrid status, the fact remains that offering and trading OneChicago's products required market participants to adjust to a whole new set of legal rules of the road. This has inhibited our growth and development, as it would any new innovative product. Based on our experience to date, we would like the Subcommittee's help in removing some of these obstacles to market acceptance of security futures.

OneChicago's Recommendations.

Some of these obstacles would not involve statutory changes, and some would. In the non-statutory category, our concerns relate to two margin issues and one registration issue. In terms of margin, we have requested that the SEC and CFTC allow a regime of portfolio margining to apply to security futures. Portfolio margin assesses financial risk based on each market participant's portfolio of futures and options contracts, rather than on an individual contract or product basis. It takes into account the extent to which related contracts in different markets, for example, Treasury Notes and Eurodollars, or corn and soybeans, have price movements in common. It allows for more efficient use of margin capital without sacrificing, and we believe enhancing, financial integrity. The futures markets have utilized portfolio margin for many years. The SEC and CFTC stated in 2002 that in a six month period they would agree to a portfolio margin regime for security futures. More than two years later, we are still waiting. We would ask the Subcommittee to support the inclusion of committee report language in connection with the CFTC Reauthorization bill to encourage the agencies to move on this important initiative.

One source of liquidity for any market is its market-makers. Encouraging market making activity is therefore an important element in creating the critical mass of liquidity that is essential to narrowing bid-ask spreads that will be attractive to customers and to providing sufficient market depth so that investors who establish positions will know they can exit the

market efficiently and at a fair price. Market-makers also are not interested in maintaining positions with market exposure for extended periods of time, let alone overnight. For these reasons, market-makers typically enjoy special, lower margin requirements than other traders. OneChicago negotiated special market-maker margin rules with the SEC and CFTC. Unfortunately, those rules have proven to be more complicated and impractical to apply than anyone contemplated. We would like to see those rules streamlined and relaxed. OneChicago will be entering into discussions with the SEC and CFTC to achieve that purpose and to amend those rules. We would greatly appreciate the Subcommittee's support, perhaps again in Committee report language, in that endeavor.

Finally, an issue has arisen whereby CFTC-registered commodity trading advisors have been discouraged from directing trading toward the security futures markets because they fear they will be required to register as investment advisers with the SEC if they do. This legal uncertainty has had a chilling effect on participation by many financial institutions and other pools of investment capital. Again, we would appreciate this Subcommittee's assistance in obtaining a clear, bright-line test that allows CTA's to participate in security futures without fear of triggering SEC investment adviser registration.

In terms of statutory changes, we would recommend three changes, two of which are within the jurisdiction of the Agriculture Committee and one which is not. First, the level of initial and maintenance margin for security futures has been the subject of discussion from the very beginning. After much negotiation, the CFMA linked security futures margins to stock options margins, essentially at 20% of notional value. That level has proven, quite simply, to be unnecessarily high and has imposed an unwarranted cost that has discouraged new customers from using our products. While the agencies could allow for a reduction of the levels of margin without a statutory change, in light of the perceived sensitivity of this issue we would recommend that Congress amend the statute specifically to authorize margin levels at 15% of notional value. That level in almost all instances would satisfy the systemic risk and financial integrity concerns that generally animate margin-setting without imposing too high a barrier to entry of new positions.

Suitability is the next area. Generally, the futures industry operates under a "know your customer" rule and not a "suitability" rule as is applicable to securities markets. The CFMA requires futures commission merchants and other futures professionals to satisfy the same suitability requirements as they would have under the securities laws. As a substantive matter of customer protection, we do not believe there is a material difference in these two approaches. But fear of the unknown application of securities suitability standards has caused many futures firms to be unwilling to recommend or broker security futures trades. Since the real purpose of the CFMA's provision was to make sure customers are adequately protected and NFA's "know your customer" rule serves in every material respect the same customer protection purposes as a suitability rule, we would urge Congress to change the statute to allow futures professionals to meet either a "know your customer" or a "suitability" rule imposed by an SRO in dealing in securities futures.

Taxation is the last area. As this Subcommittee well knows, the special nature of futures trading has for many years justified a regime of 60-40 treatment for futures dealers. During the CFMA, one issue Congress considered was the proper tax treatment of gains and

losses from trading and market making in security futures contracts, including the extent to which 60/40 treatment should be accorded to dealers. Congress decided that dealers in security futures should receive 60-40 treatment. The definition of dealer in that context was left to the Secretary of the Treasury. Congress stated that the definition of security futures dealer should be made consistent with the generally recognized purpose of providing:

”comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.”

H.R. Conf. Rep. No. 106-1033, 106th Cong., 2d Sess. 1036 (2000) (emphasis added).

Despite this guidance and despite the good faith efforts of all interested parties, the ultimate determination of dealer status for tax purposes was made in a way that is unduly complicated and gives securities futures less favorable treatment than is afforded to securities options. To remedy this disparity, OneChicago would recommend a bright-line test that allows all members of an exchange trading security futures to qualify for 60-40 tax treatment for their securities futures trading activity. In addition to achieving practical comparability with securities options, this approach would allow members of futures exchanges to experience the same tax treatment for security futures as they have for other futures trading activity.

Conclusion.

OneChicago thanks the Subcommittee for its interest in, and attention to, the development of a successful U.S. security futures market. We would greatly appreciate your consideration of our modest list of reforms to the regulation of our market which we believe will strongly serve the public interest and the national interest. We would be happy to answer any questions you may have.

Product	Average Daily Volume	Monthly Volume	Previous Year Monthly Volume	% Change	Year to Date Cumulative Volume	Month End Open Interest
Exchange Total	2,993	56,858	51,821	10%	242,586	178,576
ETF Futures	31	584	1,572	-63%	2,330	2,777
Single Stock Futures	2,960	56,232	49,952	13%	240,042	175,584
MicroSector Futures	2	42	297	-86%	214	215

ETF Futures						
DIAMONDS® (DIA1C)	31	584	1,572	-63%	2,330	2,777

Single Stock Futures						
Alcoa Inc. (AA1C)	4	76	643	(1)	1,781	1,537
Apple Computer Inc. (AAP1C)	91	1,723	n/a	n/a	2,805	729
American International Group (AIG1C)	9	179	24	646%	249	234
Allstate Corp. (ALL1C)	2	33	n/a	n/a	2,330	2,392
Altera Corp. (ALTR1C)	37	702	414	70%	1,212	69
Applied Materials (AMAT1C)	21	406	826	-51%	691	51
Advanced Micro Devices Inc. (AMD1C)	17	331	n/a	n/a	15,891	11,212
Amgen Inc. (AMGN1C)	130	2,466	999	147%	9,376	1,585
Amazon.com Inc. (AMZN1C)	37	707	887	-20%	1,668	179
American Express (AXP1C)	8	153	106	44%	2,721	5,836
Boeing Co. (BA1C)	5	92	48	92%	216	65
Bank Of America Corp (BAC1C)	1	22	123	-82%	10,134	5,518
Bed Bath & Beyond (BBBY1C)	22	410	48	754%	914	85
Best Buy Company Inc. (BBY1C)	8	157	35	349%	277	6
Biogen Idec Inc. (BIB1C)	24	460	546	-16%	904	85
Bristol-Myers Squibb Co. (BMY1C)	1	14	557	-97%	91	25
Broadcom Communications Sys. (BRCD1C)	12	235	344	-32%	834	140
Broadcom Corp-Cl A (BRCM1C)	41	774	838	-8%	1,850	245
Boston Scientific Corp. (BSX1C)	8	149	n/a	n/a	299	61
Citigroup Inc. (C1C)	3	66	53	25%	109	165
Computer Associates Intl Inc. (CA1C)	20	389	n/a	n/a	489	25
Caterpillar (CAT1C)	22	414	141	194%	1,060	343
Cephalon Inc. (CEPH1C)	1	19	73	-74%	79	13
Check Point Software Tech (CHKP1C)	20	382	1,573	-76%	814	44
Comcast Corp. (CMCS1C)	6	122	41	198%	192	30
Chicago Mercantile Holdings Inc. (CME1C)	1	27	n/a	n/a	67	18
Comverse Technology Inc. (CMVT1C)	6	115	146	-21%	229	63
Cisco Systems Inc. (CSCO1C)	41	781	990	-21%	1,597	457
ChevronTexaco Corp. (CVX1C)	4	78	101	-23%	458	27
Dupont (E.I. Du Pont de Nemours Co.)	3	59	52	13%	78	33
Dell Computer Corp. (DELL1C)	45	858	491	75%	5,536	7,723
Walt Disney Co. (DIS1C)	3	53	2,412	-98%	57	47
DOW Chemical Co. (DOW1C)	1	10	237	-96%	31	9
eBay Inc. (EBAY1C)	173	3,295	1,297	154%	8,852	783
Electronic Data Systems Corp. (EDS1C)	2	41	n/a	n/a	83	44
Eastman Kodak (EK1C)	3	57	46	24%	2,974	6,916
Elan Corp. PLC (ELN1C)	13	284	n/a	n/a	361	155
Emulex Corp. (ELX1C)	2	40	3,209	-99%	106	4
EMC Corp. (EMC1C)	3	51	n/a	n/a	235	8
Ford Motor Co. (F1C)	1	28	83	-66%	62	51
Federated Department Stores (FD1C)	8	149	n/a	n/a	389	21
General Electric Co. (GE1C)	68	1,283	407	215%	7,473	2,080
Genzyme Corp - Genl Division (GENZ1C)	27	504	294	71%	1,098	81
General Motors Corp. (GM1C)	8	150	19	689%	6,078	1,567
Google Inc. (GOOG1C)	94	1,781	n/a	n/a	4,474	2,057
Goldman Sachs Group Inc. (GS1C)	20	379	470	-19%	613	159
Halliburton Co. (HAL1C)	66	1,262	60	2003%	7,254	6,220
Home Depot Inc. (HD1C)	-	2	12	-83%	68	3
Honeywell International Inc. (HON1C)	12	222	540	-59%	241	3,847
Hewlett-Packard Co. (HPQ1C)	4	70	616	-89%	278	90
International Business Machines (IBM1C)	7	134	394	-66%	4,686	2,313

Intel Corp. (INTC1C)	20	384	4,562	-92%	1,090	2,379
International Paper Co. (IP1C)	2	30	89	-49%	61	14
Jet Blue Airways Inc. (JB1C)	-	2	-	n/a	540	21
Johansen & Johnson (JN1C)	181	3,063	57	5274%	7,842	7,551
Juniper Networks (JNPR1C)	15	286	-	n/a	735	149
J.P. Morgan Chase Co. (JPM1C)	1	76	40	-33%	6,909	3,444
KLA-Tencor Corp. (KLAC1C)	51	983	855	13%	1,801	34
Kroger Co. (KR1C)	4	83	105	-21%	5,216	6,099
Kohl's Corp. (KSS1C)	4	73	-	n/a	189	-
Lanner Corp. (LBR1C)	27	511	-	n/a	1,047	210
Linear Technology Corp. (LTTC1C)	21	390	358	9%	1,701	114
EB-Lyondell Co. (LY1C)	7	124	-	n/a	2,489	4,144
Limited Brands Inc. (LTD1C)	-	-	-	n/a	-	40
McDonald's Corp. (MCD1C)	8	171	6,394	-97%	4,177	10,715
Merrill Lynch Co. Inc. (MER1C)	2	32	152	-79%	44	47
3M Co. (MMM1C)	13	241	218	11%	393	150
Altria Corp. (R1C)	1	23	52	-65%	2,110	2,019
Motorola Inc. (MOT1C)	5	98	335	{1}	417	67
Motorola Inc. (MOT2C)	-	2	-	n/a	-	1,040
Bank of America (BAC1C)	5	91	29	214%	182	2,690
Microsoft Corp. (MSFT1C)	5	83	391	-77%	296	8,941
Nokia Technology Inc. (NT1C)	1	25	1,186	-98%	717	160
Morgan Stanley (MS1C)	2	40	121	-67%	19	16
Maxim Integrated Products Inc. (MXIM1C)	25	480	1,246	-62%	1,039	178
Newmont Mining Corp. (NEM1C)	30	724	227	219%	1,079	112
Northrop Grumman Corp. (NOC1C)	181	3,054	59	5069%	3,057	3,099
Nokia Corp. ADR (NOK1C)	13	242	759	-68%	566	147
Nvidia Corp. (NVDA1C)	51	978	196	398%	1,636	214
Novellus Systems Inc. (NVL1C)	30	570	589	-3%	1,009	100
Noratel Communications Inc. (NOC2C)	181	6,183	716	764%	12,371	5,167
Oracle Corp. (ORCL1C)	15	286	364	-21%	865	208
Pfizer (PFE1C)	23	483	-	n/a	1,187	23
PepperCo Inc. (PEPC1C)	2	31	84	-63%	47	18
Procter & Gamble (PG1C)	108	2,047	81	2427%	6,996	5,065
Procter & Gamble Co. (PG2C)	4	70	421	-83%	459	57
PHC Sierra Inc. (PHCS1C)	29	543	-	n/a	1,378	335
QUALCOMM Inc. (QCOM1C)	23	440	1,816	-76%	1,302	345
Qualgate Corp. (QLGC1C)	30	577	392	47%	1,150	104
Reynolds American Inc. (RA1C)	46	876	-	n/a	877	1,100
Research in Motion Ltd. (RIM1C)	81	1,538	-	n/a	1,921	182
SBC Communications Inc. (SBC1C)	1	22	15	47%	18,382	5,006
Starbucks Corp. (SBUX1C)	39	748	1,323	-44%	1,428	218
Siebel Systems Inc. (SEB1C)	2	35	93	-62%	467	105
Schering-Plough Corp. (SPL1C)	4	71	-	n/a	2,284	10,081
Sinus Satellite Radio Inc.	14	263	-	n/a	956	222
Schlumberger Ltd. (SLB1C)	39	750	125	500%	3,172	3,825
Sandisk Corp. (SNDK1C)	77	1,465	817	79%	2,220	146
Sun Microsystems (SUNW1C)	18	349	844	-59%	980	426
Symantec Corp. (SYMC1C)	10	191	545	-65%	1,001	151
AT&T Corp. (T1C)	4	61	59	37%	133	24
Target Corp. (TGT1C)	24	447	-	n/a	701	90
Tenet Healthcare (TNC1C)	-	2	-	n/a	82	-
TIBCO Software Inc. (TIBX1C)	12	219	810	-73%	377	119
Time Warner Inc. (TWX1C)	6	133	59	92%	165	34
Texas Instruments Inc. (TXN1C)	10	184	340	-46%	327	79
Tyco International Ltd. (TYCO1C)	5	95	434	-78%	117	56
United Parcel Service Inc. (UPS1C)	-	-	-	n/a	6	4
U.S. Bancorp (USB1C)	24	459	-	n/a	716	459
United Technologies Corp. (UTX1C)	6	107	407	-74%	119	18
Verizon Inc. (VZ1C)	-	7	-	n/a	4,304	6,296
VERITAS Software Corp. (VRTS1C)	4	69	308	-78%	320	25
Verizon Communications Inc. (VZ2C)	4	78	50	52%	10,758	5,001
Wells Fargo & Co. (WFC1C)	41	774	118	556%	3,717	6,627
Williams-Sonoma Inc. (WS1C)	1	25	-	n/a	48	1
Wal-Mart Stores Inc. (WMT1C)	14	279	77	251%	382	3,853
Xilinx Inc. (XLNX1C)	11	208	541	-62%	374	122
Exxon Mobil Corp. (XOM1C)	6	116	81	43%	260	1,631
Yahoo! Inc. (YHOO1C)	57	1,061	475	128%	2,632	389

Futures on Dow Jones MicroSector Indexes™						
Aerospace (XAR09C)	-	-	-	n/a	8	8
Biotechnology (XBTC9C)	-	-	24	-100%	-	25
Communications Technology (XCMT9C)	-	-	-	n/a	39	31
Industrial, Diversified (XIDD9C)	-	8	31	-74%	18	45
Investment Services (XSIA9C)	1	14	72	-81%	36	4
Pharmaceuticals (XDRG9C)	1	20	10	100%	113	101
Precious Metals (XPC59C)	-	-	5	-100%	-	1

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Testimony of**Terrence Duffy,
Chairman of Chicago Mercantile Exchange Holdings, Inc.****Before the
House Agriculture Subcommittee on General
Farm Commodities and Risk Management****March 9, 2005**

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

I. OVERVIEW OF CFMA: HISTORIC AND SUCCESSFUL LEGISLATION

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

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

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

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

By illustration I would point out the following:

- Continuing the trend since the CFMA's enactment in late 2000, CME's average daily volume in February has increased more than 50% over the comparable period in 2004, when our average daily volume exceeded 3.8 million contracts, an all-time record.
- Electronic trading volume on CME® Globex® grew to more than 2.5 million contracts per day, representing 66% of total exchange volume in February.
- CME's Eurodollar futures contract remains the benchmark interest rate product around the world, commanding 97% of the daily trading volume. Average daily volume of CME Eurodollar futures on CME Globex in February exceeded 1.2 million contracts. This represented 77 percent of total CME Eurodollar volume in February compared with 15 percent in February 2004.
- CME's FX markets hit an all-time volume record in February as average daily volume totaled more than 266,000 contracts, representing notional value of \$35 billion per day and an increase of 49% from one year earlier. During the month, CME electronic foreign exchange products increased 83 percent from the same period one year ago to reach 210,000 contracts per day.
- Trading in CME E-mini™ equity index products averaged 1.1 million contracts per day in February, up 16 percent versus the same period last year.
- CME's commodity products also continue to trade well, with average daily volume in February at 43,000 contracts, up 35 percent from one year ago.

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

II. CFMA HAS FOSTERED INNOVATION IN SELF-REGULATION

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

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

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

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

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

- to oversee the performance of the Market Regulation Department and Audit Department so that each department is able to implement its self-regulatory responsibilities independent of any improper interference or conflict of interest that may arise as a result of a member of CME serving on the Board or participating in the implementation of CME's self-regulatory functions;
- to review the annual performance evaluations and compensation determinations and any termination decisions made by senior management of CME with respect to the Managing Director, Regulatory Affairs, and the Director, Audit Department, so that such determinations or decisions are not designed to influence improperly the independent exercise of their self-regulatory responsibilities;
- to review CME's compliance with its self-regulatory responsibilities as prescribed by statute and the rules and regulations promulgated thereunder; and
- to review changes (or proposed changes, as appropriate) to Exchange rules to the extent that such rules are likely to impact significantly the self-regulatory functions of the Exchange.

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

III. CFMA HAS FOSTERED PRODUCT AND MARKET INNOVATION

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

- Technology innovation;
- Continued product innovation;
- Expanding global distribution; and
- Leveraging the convergence of the cash, derivatives and over-the-counter (OTC) markets.

Technology Innovation:

In terms of technology innovation, we have redesigned our business model to leverage our electronic trading capability. A sign of our successful transformation is that five years ago, CME had 125 people focused on technology. Today, we have over 400 talented technologists, reflecting our view of the future. CME Globex today significantly outperforms its competitors by facilitating trading around the world more than 23 hours a day, five days a week and with a 150 to 200 millisecond average turnaround time.

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

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

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

Products:

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

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

This has fueled growth in each of our major product lines. For example, electronic trading of CME Eurodollar futures increased by 1,248 percent from 2003 to 2004. Our success is attributable to enhanced technology functionality, significant

reductions in CME Eurodollar trading fees on CME Globex, and the implementation of our new CME Eurodollar market maker program – all of which has substantially enhanced liquidity on CME Globex.

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

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

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

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

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

Expanding Global Distribution:

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

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

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

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

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

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

Common Clearing Link:

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

IV. CME's RECOMMENDATIONS FOR REAUTHORIZATION

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

Off-Exchange Retail Futures Trading:

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

CFMA addresses retail foreign exchange futures and the threshold definition of what transactions should be subject to CFTC jurisdiction.

The fact that the CFTC is compelled to devote such substantial resources to protecting retail customers from significant fraud is evidence enough that a serious problem exists with the CFMA that cries out for reform. Moreover, in the aftermath of the Zelener decision, a retail product that most would agree is a futures contract--- but which has now been defined by the court to be a cash product---can be offered outside of the CFTC's jurisdiction. The sharp operators and bucket shops have already figured out that the rationale of the Zelener opinion can apply to commodities other than FX. How soon will it be before the CFTC's jurisdiction and its retail consumer protections are reduced to irrelevance?

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

Security Futures Products:

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

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

V. CONCLUSION:

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

**Testimony of John G. Gaine, President, Managed Funds Association
Before the General Farm Commodities and Risk Management Subcommittee
of the House Committee on Agriculture
United States House of Representatives
March 9, 2005**

Mr. Chairman and Members of this Subcommittee, my name is John G. Gaine and I am the President of Managed Funds Association (“MFA”). MFA appreciates the opportunity to provide testimony for the Subcommittee’s consideration in connection with the reauthorization of the Commodity Futures Trading Commission (the “Commission” or the “CFTC”).

We commend the Subcommittee for this timely hearing and for its leadership during the last reauthorization process, which ultimately led to the adoption of the Commodity Futures Modernization Act of 2000 (“CFMA”), a law we believe has served our industry and the U.S. capital markets extremely well. The CFTC equally deserves significant credit for a steady, sensible hand in implementing the CFMA for the past four years. Because of the many positive aspects of this law, as I will explain in my testimony, MFA is not advocating any statutory change at this time. If Congress does decide to change the existing law, we believe it should do so carefully while preserving the ideals of the CFMA.

About MFA

MFA is the primary trade association representing professionals who specialize in the management of alternative investments, including hedge funds, funds of funds and managed futures funds. MFA has over 850 members, including representatives of 35 of the 50 largest hedge fund groups in the world. Our members, many of whom represent firms that are registered with the CFTC as commodity trading advisors (“CTAs”) and commodity pool operators (“CPOs”), manage a substantial portion of the over \$1 trillion invested in alternative investment products globally.

MFA has been a vocal advocate for sound and sensible public policy in this important sector of the financial world—a sector that provides many benefits to the global marketplace. Our members offer investors the ability to diversify their portfolios in a meaningful way by providing investment products that perform in a manner that is not correlated to the performance of more traditional stock and bond investments. These alternative investment vehicles provide liquidity to the futures and other markets, which serves to increase the efficiency of the price discovery and hedging functions of these markets.

As major customers of futures exchanges, futures commission merchants as well as other futures industry services, many of MFA’s members directly benefit from the provisions of the Commodity Exchange Act (the “CEA”) and, in particular, the modernizations brought about by the CFMA. The Commission’s oversight of the functioning of and participation in futures markets has an important impact on CPOs, CTAs and their clients. Furthermore, many aspects of MFA members’ business

operations (such as sales, promotional, registration and operational activities) are also subject to regulation by the National Futures Association (“NFA”)—the industry’s self-regulatory organization. The Commission and the NFA oversee the business activities of CPOs and CTAs through registration, disclosure, anti-fraud, recordkeeping and reporting requirements. Each of the futures exchanges also monitors the trading activities of our members in their respective markets.

Many of MFA’s members are subject to regulation under other federal legislation in addition to the CEA. The public offer and sale of interests in commodity funds are subject to the Securities Act of 1933 (the “1933 Act”), which requires registration of these interests and mandates certain disclosure obligations. Commodity funds are also subject to the Securities and Exchange Act of 1934, which requires the filing of certain publicly-available reports and finally to the individual securities laws of each of the 50 states. Moreover, under the Investment Advisers Act of 1940 (“Advisers Act”), most hedge fund managers will soon be required to register with the Securities and Exchange Commission (“SEC”) as investment advisers. MFA’s members also will be subject to the anti-money laundering requirements of the USA PATRIOT Act of 2001.

Since the last reauthorization in 2000, and as I testified before this Subcommittee in June 2003, MFA has worked together with the CFTC on a number of important rulemaking projects. We believe the CFTC’s efforts at reducing unnecessarily burdensome regulations, also a direct result of the CFMA, will continue to encourage greater use of futures products in the financial marketplace. Accordingly, we are delighted to be here today to discuss the importance of the CFTC and the statutory framework under which it operates to our industry.

MFA’s Response to Industry Developments

MFA has undertaken a number of private sector initiatives to promote the integrity, safety and soundness of alternative investments. Some Subcommittee Members may recall that in 1998, after the near-collapse of Long Term Capital Management, both the public and private sectors focused upon ways to reduce systemic risk in alternative investment vehicles. In 1999, one notable public sector response was the report published by the President’s Working Group on Financial Markets entitled, “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management” (the “PWG Report”). The PWG Report recommended a number of measures, both public and private, designed to enhance market discipline in constraining excess leverage. Specifically, the PWG Report recommended that hedge funds establish a set of sound practices for their risk management and internal controls. In February 2000, “Sound Practices for Hedge Fund Managers” (“Sound Practices”) was published as an industry response to this recommendation.

MFA believes that the public and private sector measures implemented in the aftermath of LTCM, such as those described in the “Sound Practices,” have successfully reduced the exposure of global financial markets to systemic risk. As a testament to this belief, MFA updated these “Sound Practices” in 2003 and is in the process of drafting another substantial update of this document for 2005. Similarly, in the anti-money

laundering context, before it was clear that hedge funds would be subject to the PATRIOT Act, MFA published its "Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs" ("Preliminary Guidance") in early 2002. Both the "Sound Practices" updates as well as the "Preliminary Guidance" are clear examples of MFA's work to respond to the goals of Congress and regulatory agencies of promoting the integrity of financial markets and their participants.

Benefits of the Alternative Investment Industry

Increased interest in and use of alternative investments is a direct result of the growing demand from institutional and other sophisticated investors for investment vehicles that deliver true diversification and help them meet their future funding obligations and other investment objectives. Our members' funds perform a number of important roles in the global marketplace, including contributing to a decrease in overall market volatility, acting as "shock absorbers" and liquidity providers by standing ready to take positions in volatile markets when other investors choose to remain on the sidelines. Fund activity also provides markets with price information, which translates into pricing efficiencies, and assists in identifying pricing inefficiencies or trouble spots in current markets. Moreover, these funds utilize state-of-the-art trading and risk management techniques that foster financial innovation and risk sophistication among market participants

Hedge Funds Effect on Energy Markets

Energy markets enjoy all of these described benefits provided by the alternative investment industry. However, there has been increasing discussion about hedge funds and their effect on the energy markets, including recently expressed interest from Members of Congress. Some market participants have argued that price swings and volatility in these markets are a result of the impact of speculative futures trading by hedge funds. Recently questioned on this topic, both the CFTC and the Federal Energy Regulatory Commission ("FERC") generally concluded that the fundamentals of free market behavior as opposed to trading activity by hedge funds drive the prices of natural gas futures. The CFTC stated "it does not believe that hedge funds are the major source of price volatility in the natural gas market."

We believe the CFTC is doing an excellent job in overseeing the energy trading market. As Acting Chairman of the CFTC Brown-Hruska recently noted, the CFTC staff is routinely in contact with staff at FERC to exchange information about natural gas futures and cash market activity. Any unusual market developments or potential concerns about contracts traded on the futures exchanges, including natural gas contracts, are reported at regular weekly surveillance briefings at the CFTC. Additionally, CFTC economists monitor prices and price relationships in and between the futures and cash markets for natural gas, with the objective of determining if there are price distortions and evidence of manipulation. Furthermore, given the unprecedented level of CFTC enforcement actions in the energy markets over the past two years, which includes assessments of approximately \$300,000,000 in penalties, we believe the agency has

shown just how prudent and aggressive it can be when it comes to pursuing wrongdoing in the marketplace. The industry, including MFA members who trade in these markets, benefit from appropriate regulatory actions since these actions promote fair and efficient pricing in the marketplace.

MFA is comfortable that this issue has been, and continues to be, appropriately monitored and that the CFTC, FERC and New York Mercantile Exchange each have correctly recognized that hedge funds are not dominating energy trading and are not the cause of price swings in the energy market. Rather, as previously discussed, hedge funds have the positive effect of increasing available liquidity and decreasing overall market volatility.

Avoidance of Duplicative Regulation

The Congressional intent of the CFMA is to avoid instances of unnecessary overlapping regulation between federal agencies and the consequent duplicative compliance costs. Our concern focuses on those hedge fund advisors registered with the CFTC as CTAs and CPOs that will now be required to also register with the SEC as investment advisers. A potential means of stemming duplicative federal agency oversight would be to define the word “primarily” as it is used in Section 203(b)(6) of the Advisers Act and in Section 4m(3) of the CEA. Under the Advisers Act, a CTA registered with the CFTC is excluded from the requirement to register with the SEC if his or her business “does not consist *primarily* of acting as an investment adviser.” A parallel exclusion from the requirement to register with the CFTC exists under the CEA for investment advisers that are registered with the SEC and “whose business does not consist *primarily* of acting as a CTA.” We believe the SEC and the CFTC should undertake to define the criteria a CTA or registered investment adviser must meet to exempt them from dual registration. Our members would greatly benefit from interpretive relief or guidance in this area. We ask this Subcommittee, through your oversight authority, to encourage these two federal agencies to work together on this and other duplicative provisions so that compliance obligations are not redundant or overly burdensome. MFA is available to provide any assistance in this matter that is helpful to the process.

Importance of the CFMA

I testified on behalf of MFA before this Subcommittee in support of the bill that became the CFMA, and we continue to be a strong supporter of the law. Its passage in December 2000 represented a landmark legislative accomplishment that set the groundwork for the regulatory structure governing today’s futures industry and led to unprecedented industry growth. The alternative investment industry also has seen significant growth over the past four plus years, due in no small part to the passage of the CFMA.

One of the central themes of the last reauthorization was the deregulation of exchanges, which has led to increased competition on a product-by-product basis. These changes have yielded dramatic benefits to investors, which we believe should continue to be the focus of the Commission reauthorization process and all future regulation and

legislation initiatives in the alternative investment industry. The CFMA provided the foundation for the advancements we have seen in the futures industry over the past few years, as I will discuss below.

CFTC Registration Exemptions

During 2002-2003, the Commission modernized the following key rules that have significantly impacted MFA members who are CPOs and CTAs:

Rule 4.13(a)(4): This rule, proposed by MFA, provides an exemption from registration with the Commission for CPOs that operate hedge funds limited to individuals that are “qualified eligible persons” under CFTC Rule 4.7 (generally with an investment portfolio of at least \$5 million) or limited to institutional investors that are at least “accredited investors” as defined in Regulation D of the 1933 Act (generally, an individual person with a net worth of \$1 million or an annual income in excess of \$200,000). This rule helped to better coordinate the CEA exemptions with those available under 3(c)(7) of the Investment Company Act of 1940 and the 1933 Act. There is a corresponding CFTC exemption for CTAs that advise pools exempt under Rule 4.13(a)(4).

Rule 4.13(a)(3)(De Minimis Exemption): The CFTC adopted this registration exemption for fund managers that engage in limited (“de minimis”) commodity interest trading. The exemption provides for a CPO registration exemption for fund managers that: (i) engage in only a “de minimis” amount of futures trading, under one of two alternative quantitative constraints, and (ii) sell only to “accredited investors.” This exemption helps to alleviate the burden of registration on hedge fund managers who use futures or options on futures only for hedging or in other very limited ways that are incidental to their securities trading.

Rule 4.5: This rule broadens the scope of the exclusion from the definition of CPO available to otherwise regulated “Qualifying Entities” (i.e., mutual funds, pension plans, insurance company separate accounts, bank trusts funds and similar otherwise regulated institutions) by eliminating the requirement that Qualifying Entities limit their commodity interest positions to a certain percentage of their overall portfolio.

MFA believes that the exemptions discussed above represent crucial relief for Commission registrants and have led to greater use of financial and commodity futures products in the financial marketplace. Prior to their adoption, many private pooled investment vehicles avoided using commodity futures and options in their trading because of the associated CPO registration requirement. The elimination of this requirement for certain funds has encouraged the growth of the futures industry as a result. We commend the CFTC for its efforts in implementing these exemptions, which we believe were important modernizations undertaken in accordance with the principles of the CFMA.

Notional Funds

With respect to performance data of notionally funded accounts, MFA supported the CFTC's decision to permit CTAs to use nominal account size as the basis for computing a client's rate of return rather than actual funds under a CTA's control. This 2003 amendment provides a uniform basis for all CTAs to present rate-of-return and allows for a more meaningful comparison of CTAs' performance results.

Bunched Orders

Also in 2003, MFA successfully worked with the CFTC and other relevant parties to adopt a fair and effective bunched order allocation structure for a broader class of account managers and customers of bunched accounts. By allowing all customers the opportunity to have their orders bunched, customers may receive better execution and better pricing of their orders.

Speculative Limits

Speculative position limits for futures contracts on various agricultural commodities has been an issue discussed at the CFTC for many years. Most recently, the CFTC requested comments on the Chicago Board of Trade's (CBOT) proposals for either the repeal or expansion of federal speculative limits applicable to certain agricultural futures and option markets under Commission Regulation 150.2.

MFA and its Members support the liberalization of federal speculative limits, and therefore urge this Subcommittee to support the CFTC in moving forward on this issue. Core Principle 5 of Section 5(d) of the CEA, applicable to designate contract markets, deals with Position Limitations or Accountability, and states that:

To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary or appropriate.

Although the Commission retains the authority to set speculative position limits pursuant to Section 4a(a) of the CEA, the most recent pronouncement of Congressional intent, as set forth in the CFMA's Core Principles, squarely places responsibility for establishing position limits upon the exchanges. Therefore, we believe adoption of this proposal is consistent with the spirit and flexibility embodied in the CFMA, and will ultimately give futures exchanges the necessary tools to respond quickly to market conditions through speculative position limit adjustments.

Conclusion

MFA supports Congressional review and evaluation of the CFTC and the regulatory framework governing the U.S. futures markets. We believe it is beneficial to periodically examine federal agencies to determine whether their operations are meeting current policy objectives. At this time, MFA is not advocating any change to the

Commodity Exchange Act or the CFTC's existing authority thereunder. We believe that the progress that was made since the 2000 reauthorization has permitted the alternative investment industry to continue its astounding growth as a vital component of the global financial marketplace. If Congress does elect to consider making any modifications, including changes to the CFTC's enforcement authority in light of the *Zelener* case, we hope that it will be mindful of preserving the ideals of the CFMA and the progress made through its adoption in modernizing the legal and regulatory framework under which the agency and our U.S. futures markets operate.

MFA hopes that the Commission will continue to implement the CFMA's goals by undertaking to harmonize the SEC and CFTC rules governing hedge funds and public commodity pools and by liberalizing federal speculative limits. Overall, MFA believes that the Commission has demonstrated its willingness to solicit and actively consider suggestions and proposals by industry participants that will lead to greater modernization, efficiency and innovation in the futures industry. I look forward to answering any questions you might have.

**Testimony of
The National Grain Trade Council
On Reauthorization of the Commodity Futures Trading Commission**

**Before the Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
U.S. House of Representatives**

March 9, 2005

Mr. Chairman and Members of the Subcommittee:

Good morning. My name is George Hanley and I am president of Hanley Group based in Chicago, Illinois. I also am a member of the National Grain Trade Council (the Council) on whose behalf I appear before you this morning. The Council is a North American trade association that brings together grain exchanges, boards of trade, and national grain marketing organizations with their grain industry counterparts including grain companies, millers and processors, railroads, futures commission merchants, and banks. The Council's mix of membership provides it with a unique perspective on futures trading issues, such as reauthorization of the Commodity Futures Trading Commission. We have shared our expertise in this arena with you on numerous occasions in the past and we welcome the opportunity to do so again today.

As an overview of our testimony, the National Grain Trade Council supports the movement from prescriptive regulation to the core principles of the Commodity Futures Modernization Act of 2000 (CFMA). The Council and its members are very pleased with how the CFMA has been implemented and the industry has prospered under it. Since 2000, the futures industry has experienced strong growth in volume and in the types of products available. The CFMA ushered in an environment that allows for advances in technology, such as electronic trading, that would not have occurred as efficiently or as rapidly under more restrictive regulation and oversight. In general, the Council views the CFMA as very effective at achieving its goals.

The Council strongly believes that price discovery, the fundamental goal of a regulatory structure, is best accomplished by vesting responsibility with exchanges and providing the Commodity Futures Trading Commission (CFTC) with the necessary tools for oversight authority and meaningful regulation. In the spirit of the CFMA, we advocate leveling the playing field between agricultural commodities and other physical commodities. The Council believes that enumerating agricultural commodities no longer advances the public policy goals originally envisioned.

When discussing meaningful regulation, we make several recommendations regarding approval for increases of speculative position limits, the agricultural trade options program, and the application process for new contract markets. Finally, the Council would like to draw your attention to the negative impact Financial Accounting Statement 133 is having on commodity markets.

Equitable Treatment for Agricultural Commodities

The Council believes that enumerating agricultural commodities under the CFMA no longer serves to advance public policy. Agricultural markets have matured, especially under the CFMA, and the more prescriptive regulation is no longer necessary to protect the markets or the market participants. Modern US agricultural futures and options markets are much deeper, draw significant representation from worldwide commercial hedging interests, and offer greater trading opportunities for a speculative community whose participation is as essential for the success of our markets as farmer and commercial hedging communities. Trading volume is high and growing each year – testimony to the solid connection between US exchange prices and the underlying prices of domestic and internationally traded physical commodities. As the CFTC moves toward becoming more of an oversight authority under the CFMA, Congress may want to consider whether the regulatory structure should recognize the maturity of the agricultural markets and put them on parity with the other physical commodity markets.

Speculative Position Limits

The Council supports the petitions of the Chicago Board of Trade, the Kansas City Board of Trade, and the Minneapolis Grain Exchange for repeal or amendment of speculative position limits. The Council strongly believes that exchanges should be responsible for setting speculative position limits, subject to the Commission's oversight; however, if federal speculative position limits are retained, the Council supports increasing the limits and the maintenance of parity across wheat exchanges.

By eliminating federal speculative position limits, the Council believes two goals would be accomplished: 1) reduction in duplicative regulatory oversight and 2) greater market transparency. Core Principle 5(d) of the CFMA requires boards of trade to adopt position limits where necessary and appropriate, subject to the oversight of the CFTC; however, a small subset of agricultural commodities continue to be subject to the jurisdiction of the CFTC.

Currently, exchanges must go through the self-regulatory process to change their rules to allow for an increase in limits. Then, they must petition the CFTC to modify its rules to permit such an increase. This duplicative regulatory structure is different from other contracts and different even from other agricultural contracts. Elimination of the regulatory redundancy would fully implement the core principals of the CFMA for all agricultural commodities and allow exchanges to respond quickly to the ever-changing market conditions, while retaining CFTC oversight. The CFMA pushes the regulatory structure to permit greater self-regulation of the markets. Allowing exchanges to set speculative position limits, subject to the guidelines and oversight of the CFTC, is part of achieving that goal.

Furthermore, allowing exchanges to increase speculative position limits would also increase activity in a transparent marketplace and allow exchanges to compete more efficiently with over-the-counter markets. If a transaction exceeds the current limits, the transaction moves off-exchange, to a less transparent market. The Council strongly believes that streamlining the process helps all market participants at all levels by increasing activity in a transparent marketplace and increasing liquidity.

We would also like to bring to your attention our concern that funds are taking a position in agricultural indexes of sufficient size to justify petitioning the CFTC for a hedge exemption. In our view, this has the potential to present a misleading perception of commercial participation versus speculative participation in agriculture markets. As this issue moves forward, we believe the definition of a commercial participant should be carefully assessed.

Agricultural Trade Options

Another issue that warrants further review by the CFTC is the agricultural trade options (ATO) pilot program. The Council supports the comments of Acting Chairman Brown-Hruska¹ on the need to make viable risk-management tools, like ATOs, available for producers.

Under the ATO pilot program, only one entity has registered as an ATO merchant, and according to Commission records, this merchant enters into a small number of options each year. The program has not met the expectations of producers, industry or the CFTC. We commend Acting Chairman Brown-Hruska for being open to revitalizing the program. Over the years, the Council has watched the CFTC and industry wrestle with ideas on how to make the ATO program more productive, but at this point, the Council does not believe that the existing framework is workable.

Instead, the Council believes that now is the time to consider a fresh start. Over the last four years, the industry has seen remarkable innovation in the energy and metals markets. Products continue to improve and the industry continues to develop better tools for managing risk. The Council suggests tapping into that innovation and putting it to work to deliver a risk management tool for producers that is both valuable and effective. In our view, before such tools can be developed, the CFTC and the industry must begin by defining the pool of potential market participants, including examining who should be a commercial participant and what is the appropriate level of creditworthiness.

The Council, working in concert with you, the CFTC, industry and other affected parties is eager to develop such a program.

Application Transparency

The Council champions market competitiveness but believes that transparency is an essential element when introducing new exchanges to the market. We, like the CFTC, believe that it is

¹ Sharon Brown-Hruska, "The Future of Futures" (February 3, 2005) available at <http://www.cftc.gov>; "National Grain and Feed Association Seminar on Trading, Trade Rules, and Dispute Resolution" (May 4, 2004) available at <http://www.cftc.gov>. "While the utility of [agricultural trade options] is clear, we have a regulatory program that is perceived by practically all elevator operators and other potential agricultural trade option merchants to be too burdensome to be worth the effort to offer the instruments. . . [E]ven as agriculture, and the grain trade specifically, have to contend with increased global competition, and with price volatility and the uncertainty that comes with it, some of the more useful innovations, risk management products, and technologies that have been developed and are widely in use in other industry sectors have not been offered and remain unavailable to the agricultural community. . . Since becoming a Commissioner at the CFTC, what has concerned me more than anything is the lack of availability of such products in the OTC markets that would work for the agriculture industry."

imperative that the regulatory framework seeks to prevent market manipulation, protect customers, provide financial integrity and promote market transparency. To ensure this is accomplished, we believe the application review process for a new exchange must be informed, deliberative, complete and accurate.

The CFMA lowered many regulatory hurdles, making it easier for new entrants to participate in the marketplace. Over the last four years, the market and the CFTC have had an opportunity to adjust to the regime change. Now is the time to draw from our experiences and examine the application process for new exchanges to ensure that there is enough opportunity for discussion and debate. Business plans and marketing today are dramatically different than when many of our existing exchanges originally registered. The Council believes that the application process should ensure that the CFTC, the marketplace and the public receive full and consistent information about new applicants.

FAS 133

Though we understand that financial accounting statements are outside the jurisdiction of the CFTC, the Council believes that it is important to bring to your attention the negative impact Financial Accounting Statement 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities, is having on the commodity markets. Under FAS 133, financial firms are allowed to hedge various components that determine a financial asset's price. Allowing agricultural commodity hedgers to hedge components of a finished product would promote greater market participation and more accurate reporting of financial condition.

FAS 133 requires a grain or food processor to report, under certain market conditions, the interim gains or losses from the futures hedge, but it may not report the offsetting losses or gains from the change in price of the physical commodity - as though the movement in the price of the hedge instrument has no relation to the movement of the price of the physical commodity that was hedged². This occurs primarily because FAS 133 prohibits grain processors from hedging components of non-financial assets. Grain processors often hedge one or more ingredients of a finished product that they purchase and use in their manufacturing process, not the finished product itself. This is done because there may not be a viable way to hedge every ingredient of the finished product or prices of certain components of the finished product may be set by an agreement with the supplier. By comparison, financial firms are allowed to designate whether they are hedging the interest rate risk component or credit risk component of a financial asset or liability.

Decades of experience have shown that the Financial Accounting Standard Board's (FASB) assumption that the price of the hedge instrument has no relation to the movement of the price of the physical commodity is incorrect. Properly constructed hedges significantly reduce risk for a processor or other user of grain. The demand for such hedges underlies the health of the entire

² For example, a grain processor might in January enter into a cash transaction calling for physical delivery to occur in June, employing an offsetting futures market hedge transaction in a July futures contract. Under FAS 133, the processor must report the interim gains or losses from the futures hedge, but may not report the offsetting losses or gains from the change in price of the physical commodity - as though the movement in the price of the hedge instrument (in this case, July futures) has no relation to the movement of the price of the physical commodity that was hedged.

US grain marketing system, from country elevators publishing daily bids to farmers for cash delivery of grain for daily, weekly and monthly calendar positions in some cases more than a year in the future, to grain processors and livestock producers who depend on the ability to price commodity inputs accurately in spot and forward markets. Any accounting standard that interrupts this tested system diminishes marketing opportunities for farmers, increases risk for grain handlers and consumers across the marketing spectrum, and reduces participation and liquidity in futures and options markets, to the detriment of all participants.

The negative effects of FAS 133 on the futures market are real. Grain and food processors must either misrepresent their financial state to comply with FAS 133 or opt to not participate in the market. Many firms without the internal expertise or staff necessary to deal with the onerous rules have simply opted to avoid hedging, thus increasing their risks and limiting business for the hedging community. Either result, misrepresentation of financial condition or inhibiting market participation, is an undesirable outcome.

The Council, in conjunction with other industry groups, has petitioned the FASB to make changes but, so far, our efforts have been unsuccessful. To rectify this problem, we have asked FASB to grant agricultural commodity hedgers the same ability granted to financial hedgers. The Council would welcome the opportunity to discuss this issue with you in greater detail.

Conclusion

In conclusion, Mr. Chairman, we compliment you and Mr. Etheridge for your efforts. The Council supports the advances made under the CFMA. We are very pleased with the direction in which we are headed and look forward to working with you on solutions that continue to push the industry toward ever more efficient and meaningful regulation.

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March 9, 2005

**Statement of
Micah S. Green, President
The Bond Market Association**

**Before the
Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
U.S. House of Representatives**

**The Honorable Jerry Moran
Chairman**

**Hearing on
The Reauthorization of the Commodity Futures Modernization Act**

The Bond Market Association (TBMA) is pleased to present this testimony on issues related to the reauthorization of the Commodities Exchange Act (CEA). Through our offices in New York, Washington and London, the Association represents the \$44 trillion global bond markets. Our members include securities firms and banks that underwrite and trade fixed-income securities and related derivative products. The Association also represents the interests of the securitization industry through our Mortgage-Backed Securities and Securitized Products Division and our affiliated organizations, the American Securitization Forum and the European Securitization Forum. Another affiliated organization, the Asset Managers' Forum, represents the interests of institutional bond investors.

TBMA members include all 23 of the primary dealers in U.S. Treasury securities, as recognized by the Federal Reserve Bank of New York, in addition to all major dealers in federal agency bonds as well as mortgage-backed, corporate and municipal securities. Our members are also active in the markets for over-the-counter (OTC) financial contracts involving forward payments or deliveries relating to a variety of fixed-income securities, interest rates and credit products. These include swaps, repurchase agreements (repo) and forward delivery contracts.

TBMA participated actively in the debate that led to the enactment of the Commodity Futures Modernization Act of 2000 (CFMA). At that time, we advocated several



changes to the CEA that were viewed as critical to vibrant markets in OTC securities, derivatives and foreign exchange. The CFMA has proved to be extremely successful in that regard, because it clarified the exclusion from the CEA and the jurisdiction of the Commodity Futures Trading Commission (CFTC) of OTC derivatives, swaps, and foreign exchange transactions.¹ The much-needed legal certainty CFMA brought to these important sectors of the capital markets has improved efficiency in the market for U.S. Treasury securities in particular, which allows the government to borrow at a lower cost and save taxpayers money.

We commend Chairman Moran and this subcommittee for reviewing the CFMA in the reauthorization process. In this testimony, the Association would like to share with you our view of markets for fixed-income and related products and the success of the CFMA, which we believe should be left intact. In particular, we would like to highlight the notion that since the enactment of the CFMA, the markets for “cash products” such as bonds and other securities have become even more interrelated with the markets for OTC derivatives such as interest rate and credit default swaps. Maintaining the swap exclusion contained in the CEA has never been more vital.

Cash and Derivatives: Convergence in the Fixed-Income Markets

Over the last decade, and particularly over the last five years, the financial markets have undergone a major transformation in the area of risk management. Products, technologies and strategies have been developed which allow market participants to parse different types of risk and price and manage them separately from each other. This in turn allows users—including, of course, banks and securities firms, but also including corporations in practically every industry—to determine the types and levels of risk they are able to accept, and to find willing counterparties to take on, at reasonable costs, risks they are not able to retain. Whether the risk faced by a firm involves interest rates, exchange rates, defaults on credit, energy prices, metals prices, weather or any of dozens of others, that risk can be managed much more cheaply and efficiently today than ever before. Improvements in risk management at the level of individual firms has led to an overall reduction in systemic risk in the broader economy. Federal Reserve Board Chairman Alan Greenspan made this observation in 2002, telling the Council on Foreign Relations that complex financial instruments developed to manage risk have made the global economy “a far more flexible, efficient and resilient financial system than existed just a quarter-century ago.” Chairman Greenspan has reiterated this view on several subsequent occasions.

Perhaps the most important development in this area has been the rapid evolution of the market for OTC derivatives such as swaps, OTC options and forward agreements. Although markets for these products have existed for some time, the depth and liquidity of these markets in recent years have greatly enhanced the efficiency and

¹ In the case of foreign exchange, the exclusion applies when one of the parties to a contract is a regulated entity. See section 2(c) of the CEA.



reduced the cost of managing risk. A major factor contributing to this transformation of risk management is the regulatory structure for OTC derivatives set out in the CEA and clarified and enhanced in the CFMA. The CEA correctly recognizes these products as privately negotiated contracts between sophisticated commercial parties, not as publicly traded securities or futures. Unburdened by the constraints and costs of regulations that appropriately apply to the public securities and futures markets, the markets for OTC derivatives have been able to develop and flourish.

What all OTC derivatives have in common is flexibility. The fact that these contracts are negotiated between two counterparties means they can be tailored to specific needs, unlike a product such as a futures contract, the terms of which are established by the exchanges on which they trade. Although they typically are documented on industry-developed master agreements that help to standardize terms other than the basic economic terms of the contract, virtually all the terms of swap agreements are fully negotiable.

The importance of OTC derivatives is reflected in the growth in their use. Total notional² principal amount of interest rate and currency swaps outstanding has grown from around \$11 trillion at the end of 1994 to over \$161 trillion in the first half of 2004, according to the International Swaps and Derivatives Association (ISDA). In June 2003, there were \$5.4 trillion in notional amount of credit default swaps, a product which did not exist at all ten years ago.

The evolution of the OTC derivatives market over the past decade has resulted in its integration with the market for “cash products,” or traditional financial instruments such as bonds, loans and similar products. Bonds are debt securities issued by governments, corporations and others. Many OTC derivative products are instruments that represent the right to receive (or the obligation to make) payments calculated with respect to payments on an underlying debt security, loan, interest rate or exchange rate (sometimes referred to as the “reference asset”). OTC derivatives can be used either to hedge the risk from owning a position in the reference asset or to take a position that is the economic equivalent of owning the reference asset. Many counterparties are indifferent to whether they assume exposure to reference assets through the cash or derivatives markets.

The cash and derivatives markets have also converged because the dealers who make markets in these instruments are the same or related entities as those who often hedge their risks from dealing in different products on a global entity basis rather than on a product-by-product basis. The markets for bonds and similar products such as mortgage- and asset-backed securities, collateralized debt obligations (CDOs) and structured notes depend on dealers who act as market-makers³ and trading

² Notional value refers to the amount on which a contract is based, not the value at risk. In an interest rate swap for example, the notional amount refers to the amount on which an interest rate payment is calculated.

³ A “market maker” in the OTC derivatives market is a firm that stands ready to act as a counterparty in OTC transactions.



counterparties. When an investor wants to buy or sell, say, a U.S. Treasury security, he or she typically trades with a bank or securities firm acting as a dealer. The same is true for OTC derivatives. When a finance or manufacturing company wants to hedge interest rate risk, for example, the counterparty to the transaction is virtually always a bank or securities firm acting as a dealer. Because dealers serve as counterparties on a wide variety of cash and derivatives transactions, and because certain cash and derivative products tend to behave similarly under similar market conditions, dealers tend to manage their trading in these products on a consolidated basis.

The Commodity Futures Modernization Act

In 1974, when Congress amended the CEA to expand the list of commodities to which it applied, Congress recognized that it was inappropriate to apply the regulatory scheme of the CEA to certain financial products because they were not subject to the same regulatory needs as other products, or because they were adequately regulated by other regulators. For example, Congress excluded transactions in Treasury securities, foreign currency and other enumerated assets from the scope of the CEA. A regulatory exemption regarding swap transactions in the 1980s helped to further protect the burgeoning OTC derivative market, but a decade later it became clear Congress needed to act again to provide the type of legal certainty required for a vibrant OTC derivative market. During the congressional debate on the CFMA, the Association set out our three objectives for the legislation.

- Maintain the OTC markets as a viable alternative to traditional organized exchanges.
- Preserve the enforceability of contracts freely negotiated between market participants.
- Avoid duplicative and unnecessary regulation.

We commend Congress for addressing these concerns and adopting the changes to the CEA discussed below.

Excluded Commodities and Swaps

The CFMA contains a broad exclusion for qualifying transactions in “excluded” commodities. Excluded commodities are clearly defined in new section 2(d) of the CFMA and include interest rates, debt instruments and macroeconomic measures such as an inflation index, among others. The list anticipates those financial measures upon which OTC derivatives are most likely to be based. They are references to measures of risk or other economic variables rather than physical commodities. With section 2(d), the CFMA removed any doubt surrounding the

exclusion from the CEA for interest rate and credit derivatives.



The CFMA also includes a broader exclusion from the CEA for swaps than had been previously codified. Swaps between eligible contract participants (a new term defined in the CFMA) that are subject to individual negotiations and are not executed on a trading facility do not fall under the CFTC's jurisdiction. This exclusion is vital to entities using swaps to hedge risk. With this exclusion, Congress recognized that the swaps market is both important to the broader financial markets and effectively regulated. Swap counterparties are typically financial institutions that are already subject to regulation.

Exempt Commodities

The term "exempt" commodity under the CFMA refers to a commodity that is not "excluded" from the CFMA but is also not an agricultural commodity. This is an important distinction that serves to exempt OTC derivatives in energy and metals from most of the provisions of the CEA other than the anti-fraud provisions. In the wake of the Enron bankruptcy, some members of Congress have advocated new regulation for OTC derivatives in energy and metals. The CFTC's swift and successful enforcement action against Enron for manipulation of the natural gas markets has netted \$35 million in penalties to date and is a strong argument for leaving the current regulatory approach to OTC derivatives in energy and metals unchanged. The CFMA provided for the CFTC's anti-fraud authority over exempt markets, though some have questioned its applicability to bilateral and multilateral transactions. Clarification was sought in legislation last year and we look forward to working with the CFTC and Congress to resolve this question.

The Definition of Organized Exchange

Another important change under the CFMA was the clarification of the definition of "organized exchange" to essentially mean an entity that facilitates trading by or on behalf of a person that is not an eligible contract participant as defined under the CFMA. This clarification is important because it permits ongoing innovations in clearing systems and trading platforms for OTC derivatives without causing instruments traded on such facilities to become subject to the CEA. Under the revised Treasury amendment, transactions in the enumerated products are excluded from the CEA unless they are traded on an "organized exchange."

Ensure Contract Enforceability

Prior to the CFMA, market participants faced a good deal of legal uncertainty in the area of contract enforcement. Because of the lack of clarity regarding what was exempt from the CEA, counterparties could take the position that a contract was undertaken illegally off an exchange and therefore unenforceable. While such actions

were largely without merit, the need to litigate through an uncertain legal environment inhibited the development and innovation of the OTC derivative market in the United States. The clarification on enforceability found in section 22 of the CFMA is an example of another wise policy decision by Congress.



Conclusions

The CFMA strikes a delicate balance between regulating a rapidly changing market and encouraging innovation and diversity. Prior to the CFMA, the OTC derivative market was restrained by legal uncertainty. Thanks to the foresight of Congress and other policymakers, that market is now thriving and helping to save taxpayers money by lowering the cost of borrowing for the federal government. Improved risk management and lower capital costs also help stimulate the broader economy. In the context of the reauthorization process, the Association strongly urges this subcommittee and Congress not to alter any of the fundamental elements of the CFMA that encourage an orderly and innovative OTC derivative market.

**STATEMENT OF SATISH NANDAPURKAR,
CHIEF EXECUTIVE OFFICER, EUREX US,
BEFORE THE
HOUSE AGRICULTURE COMMITTEE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND
RISK MANAGEMENT
MARCH 9, 2005**

Eurex US appreciates this opportunity to testify before the Subcommittee on General Farm Commodities and Risk Management of the House Committee on Agriculture on reauthorization of the Commodity Exchange Act. We appreciate the interest shown by the House Agriculture Committee in our application for designation as a U.S. contract market and the opportunity we had to testify on it.¹ The Committee is to be commended for undertaking a thorough review of the Act, particularly the amendments enacted as the Commodity Futures Modernization Act of 2000 ("CFMA"). In the opinion of Eurex US, those amendments are working as Congress intended, namely by promoting competition, innovation, and efficiency for end users. The Commodity Futures Trading Commission ("CFTC") has adequate authority to ensure investor protection and fair competition among market participants are protected. The Committee should stay the course and encourage competition and innovation to transform the U.S. futures market further.

Introduction to Eurex US

Eurex US began operation in February 2004 as a U.S. futures exchange, registered with and regulated by the CFTC as a "designated contract market."² Our designation followed application to the CFTC, with public notice and comment. Eurex US is headquartered in the Sears Tower in Chicago and run by a U.S. management team reporting to a U.S. board of directors.

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

¹ See "The Application for Contract Market Designation of the U.S. Futures Exchange, LLC, before the Commodity Futures Trading Commission," House Agriculture Committee Hearing Serial No. 108-21, November 6, 2003.

² As a U.S. exchange, Eurex US then had to receive clearances from foreign regulators in order for participants in those countries to trade directly on the exchange. Subsequent to the CFTC's action, Eurex US received approval by regulatory authorities in the UK, France, Spain, Italy and the Netherlands, among others.

index and the small-cap Russell 2000 index. Trading volume on Eurex US reached a monthly high in November 2004 of 1.15 million contracts. Daily records were also set that month in overall volume and open interest.

Clearance and settlement services for all trades on Eurex US are provided by the Clearing Corporation in Chicago, a CFTC-registered “derivatives clearing organization.” The Clearing Corporation is a venerable financial institution that has been in operation in Chicago for 80 years and is widely regarded as a preeminent U.S. provider of futures clearing services to the financial and agricultural trading communities. Eurex US has contracted with the National Futures Association, a CFTC- licensed self-regulatory organization headquartered in Chicago, to conduct market and trade practice surveillance of the exchange and to perform other regulatory duties. The NFA is widely regarded as the leading provider of outsourced self-regulatory services to U.S. futures exchanges.

Eurex US is majority owned indirectly by Eurex Frankfurt AG, the world’s largest derivatives exchange.³ A minority ownership stake in Eurex US is held by a group of 17 U.S. and international financial institutions, including Citigroup Global Markets, Inc.; Goldman Sachs & Co.; Lehman Brothers Inc.; Morgan Stanley & Co. Inc.; and Refco LLC. These shareholders are entitled to appoint 3 of the 12 members of the Eurex US Board of Directors.⁴ Eurex Frankfurt AG nominates an additional six members of the board. Finally, three directors represent proprietary trading/arbitrage firms; institutional investors; and independent clearers respectively. Eurex US believes it has the most diverse and broadly representative board of any U.S. futures exchange.

Eurex US business model: equal access and level playing field

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

Access to Eurex US is available to all market participants who satisfy our non-discriminatory eligibility requirements. All market participants may have the benefit of direct access to the exchange, its favorable rate structure, and its competitive and non-discriminatory execution environment. Access is not artificially restricted to a limited number of market participants who benefit from the restricted membership. There are no

³ Eurex Frankfurt is in turn owned 50% by Deutsche Boerse AG and 50% by SWX Swiss Exchange. Deutsche Boerse is a publicly-traded company listed on the Frankfurt Stock Exchange, which it operates. SWX Swiss Exchange is owned by 55 financial institutions.

⁴ Kaushik Amin, Managing Director at Lehman Brothers Inc.; Bradford Levy, Vice President at Goldman Sachs & Co.; and Jeffrey Jennings, Managing Director at Morgan Stanley & Co. Inc. are currently serving as directors.

privileges and no distinction between direct and immediate access of members and indirect access of non-members as is the case on other major U.S. futures exchanges. All market participants experience an equal level of transparency and there are no informational or other trading advantages for any constituency of traders.

Trading on Eurex US is completely anonymous from the time of order entry all the way through contract settlement and delivery. Eurex US has a full, immediate, and unalterable audit trail of all activity and transactions that occur on the trading platform, ensuring that our customers enjoy the highest level of market integrity and protection.

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

Key Provisions of CFMA and their Impact

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

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

In our view, and in the view of most commentators, the CFMA unleashed a new degree of competition in the U.S. futures marketplace, resulting in greater innovation and efficiency for market participants. In fact, the CFMA was motivated in part by a desire to enable U.S. futures markets to compete more effectively, and without undue regulatory burdens, with foreign futures markets. Since enactment of the CFMA, the CFTC has

designated eight additional futures exchanges as contract markets, including Eurex US. The CFTC has also registered eight clearinghouses as “derivatives clearing organizations” during that time.⁵ This increase in competition among exchanges has, not surprisingly, been accompanied by product innovation and lower costs. Over 600 new products (including securities futures products) have been filed with the CFTC since enactment of the CFMA, with the majority “self-certified” by exchanges for immediate trading.⁶ There have been major fee reductions, including an 80% reduction in fees charged by the Chicago Board of Trade with regard to the Treasury futures products in which Eurex US competes for trading, just days before our launch.

The increased competition is transforming the U.S. futures industry in other ways as well. Market participants have had the opportunity to express their preference for immediate, anonymous, and efficient electronic trading and the exchanges have been forced to respond. Even at certain futures exchanges that maintain open outcry trading floors, electronic trading now represents over half of all trading.⁷ The result has been a phenomenal increase in U.S. futures trading volumes, from 600 million futures and options contracts traded on U.S. exchanges in 2000 to over 1.6 billion in 2004.⁸ Exchange-traded futures volume has grown much faster in the five years since 2000 than in the five years preceding it, with 2004 representing a record year for major U.S. futures exchanges.

As we testified before the House Agriculture Committee in 2003, we believed that U.S. market participants would welcome the opportunity to trade U.S. and European contracts on a low-cost, efficient, electronic designated contract market. We suspected that our entry would not only lower trading costs for U.S. market participants but would act as an engine for overall growth in the U.S. futures market, to the benefit of all markets and market users. Such seems to be the case.

Looking forward: Congress should stay the course

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

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

Thirty years ago, the United States was the only country in the world that satisfied these requirements. Today, the idea of futures markets has spread across the globe and new markets have developed around the world. European exchanges in particular introduced

⁵ “Reauthorization: Let the Debate Begin,” CFTC Commissioner Walt Lukken, Futures & Derivatives Law Report, September 2004 (“Lukken article”), at 30-31.

⁶ Lukken article at 31.

⁷ “The Future is in Futures,” speech by CME Chief Executive Officer Craig S. Donohue, FIA Law and Compliance Division, February 22, 2005.

⁸ Testimony of Sharon Brown-Hruska, Acting Chairman, Commodity Futures Trading Commission, before the House Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, U.S. House of Representatives, March 3, 2005, at 2.

electronic trading systems that attracted traders not just from their European home markets but from the rest of the world and the United States as well.

The U.S. Congress responded to these developments overseas by placing its faith in competition. By reducing barriers to competition, the CFMA ensured that greater innovation and efficiency would be the engine of growth for the U.S. futures industry. The CFMA put the U.S. futures industry in the forefront of new developments. In its way, Eurex US is trying to realize the potential created by the CFMA. We are offering the U.S. marketplace an open access, all-electronic trading venue; new products; and competitive trading in existing products. The CFMA has greatly facilitated our ability to do all these things.

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

**Testimony of
Dr. James Newsome, President
New York Mercantile Exchange, Inc.
Before the Subcommittee on
General Farm Commodities and Risk Management
United States House of Representatives
March 9, 2005**

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

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

Overview

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

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

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

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

As a result of the CFMA, NYMEX operates by choice at the highest level of regulation by CFTC under two regulatory categories for its distinct operations as a

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

I) Large Trader Reporting

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

II) Trade Register/Streetbook

NYMEX maintains a detailed and comprehensive audit trail of all transactions executed and cleared in its markets (both open outcry and electronic). Relevant data, such as trade time, executing broker or electronic trader, customer type

indicator code and the account number for the beneficial owner of the trade are collected for every executed trade in our markets. The transaction data can be reviewed by the Compliance Department with consideration for any criteria necessary.

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

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

We recently completed an analysis of hedge fund participation in several NYMEX markets during 2004, which is being submitted to the Committee for the record. NYMEX research suggests that hedge funds serve an overall constructive role in the

futures markets. While their participation has not made up a large proportion of our markets to date, we continue to monitor it closely.

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

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

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

The business of the Exchange is clearly contingent on our ability to ensure the integrity of our markets, and on the confidence of our customers and the broader

marketplace in our commitment to doing so. In the wake of the collapse of Enron and revelations about unethical trading activity by some market players, transparency and the ability to guarantee market integrity are indeed among the most critical priorities at NYMEX.

The CFMA revisions of 2000 are working as intended.

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

Finally, although the CFMA ultimately came about because of a strong consensus among a number of key industry constituencies, it is worth noting that the final bill nonetheless included a good number of delicate compromises. Consequently, changes in one area affect and thus could necessitate changes to many other aspects of the regulation.

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

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

**PREPARED STATEMENT OF
ROBERT G. PICKEL
EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.
(ISDA)
BEFORE THE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK
MANAGEMENT
COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES
MARCH 9, 2005**

Mr. Chairman and Members of the Subcommittee, I appreciate your invitation to testify on behalf of ISDA. We have appeared frequently before the Subcommittee in prior years and we welcome the opportunity to be with you today as you continue your important hearings with respect to legislation to reauthorize the Commodity Futures Trading Commission (the "CFTC"). The CFTC administers the Commodity Exchange Act (the "CEA"), which Congress substantially amended in the Commodity Futures Modernization Act of 2000 (CFMA).

I.

Overview

ISDA is an international organization, and its more than 600 members include the world's leading dealers in swaps and other off-exchange derivatives transactions (OTC derivatives). ISDA's membership also includes many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial, commodity market, credit, and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

The CFMA was adopted by Congress with broad bipartisan support after careful consideration over several years by four Congressional Committees and with the support of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. The CFMA sought to modernize the CEA by providing regulatory relief for the futures exchanges, ensuring legal certainty for OTC derivatives, and removing the ban on single-stock futures trading.

For the reasons I shall explain in this statement, ISDA believes that the experience under the CFMA demonstrates that there is no fundamental need to make substantive changes to the portions of the CMFA governing OTC derivatives. Moreover, from all indications, the CFMA seems to have been a broad-based success for the capital markets generally.

We understand that the Subcommittee will want to receive a full range of views concerning the CFMA and we believe this is desirable. We do, however, urge the Subcommittee to take a “go slow” approach to re-opening the CFMA. We also urge the Subcommittee to assert fully its jurisdiction to review and approve any changes to the CFMA. Our experience in recent years demonstrates that the use of free-standing amendments offered to separate legislation without committee review is an undesirable method of considering changes.

II.

ISDA's Interest in the CFMA

ISDA's principal interest in the CFMA are those provisions of the legislation intended to provide legal certainty for OTC derivatives. The phrase “legal certainty” means simply that the parties to an OTC derivatives transaction must be certain that their contracts will be enforceable in accordance with their terms. As discussed more fully in Part III of this Statement, the CFMA framework for providing legal certainty is based on a long-standing consensus among Congress, the CFTC and others that OTC derivatives transactions generally are not appropriately regulated as futures contracts under the CEA.

The legal certainty provisions of the CFMA were intended by Congress both to reduce systemic risk and promote financial innovation. Our experience over the past several years indicates that both of these objectives have been achieved. A survey of corporate usage of derivatives released by ISDA in April 2003 indicated that 92 percent of the world's largest businesses use OTC derivatives for risk management purposes and that 94 percent of the 196 U.S. companies included in the survey do so.

Moreover, the use of OTC derivatives to hedge interest rate, foreign currency and credit default risks increased substantially in the last four years, evidencing the importance of OTC derivatives as a tool to manage risk in periods of economic downturn and uncertainty.¹ As Federal Reserve Chairman Alan Greenspan noted before the Senate Banking Committee on March 2, 2002, OTC derivatives "are a major contributor to the flexibility and resiliency of our financial system." The reduction in systemic risk resulting from the use of OTC derivatives was also evident in the energy markets following the collapse of Enron in 2001. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted by Congress in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron.

The reductions in systemic risk resulting from enactment of the legal certainty provisions of the CFMA have not come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since enactment of the CFMA. For example, the significant growth in credit default swaps to manage credit risk has been greatly enhanced by the legal certainty provisions of the CFMA. Similarly, businesses ranging from ski resorts to beverage producers have begun to use weather derivatives to hedge the risk of adverse climate conditions on their businesses. Again, the legal certainty provisions of the CFMA have encouraged dealers to develop, and businesses to use, an increasing range of new kinds of OTC derivatives to manage additional types of risk. Finally, the legal certainty provisions of the CFMA removed the regulatory barriers to clearing with respect to OTC derivatives and, while collateralized transactions remain more prevalent, clearing proposals have been advanced recently and

¹ See Exhibit 1 (Derivatives Growth, 2000-2004, Source: ISDA).

the emergence of these proposals attests to the positive effects of the CFMA on financial innovation.

For these reasons, ISDA shares the view expressed by CFTC Chairman Sharon Brown-Hruska that the CFMA “functions exceptionally well.” In this connection ISDA believes that the CFTC deserves commendation for the evenhanded manner in which it has interpreted and administered the CFMA in accordance with Congressional intent, as well as for its vigorous program of enforcement following the collapse of Enron and the California energy situation. ISDA's primary members are substantial users of the regulated futures exchanges. ISDA therefore supported the provisions of the CFMA that provided regulatory relief to the exchanges and since then has welcomed the actions of the CFTC in implementing those portions of the CFMA in a manner that appears likely to promote efficiency and competition.

The legal certainty agenda remains incomplete, despite the historic advances embodied in the CFMA. Congress still needs to focus on completing action on the financial contract netting provisions contained in the pending bankruptcy reform legislation. These provisions have broad bipartisan support, have passed both the House and the Senate on multiple occasions without opposition, reflect years of work by the President’s Working Group on Financial Markets and include much needed improvement to the payment risk reduction and netting provisions of the Bankruptcy Code and the bank insolvency laws.

III.

Development of the Legal Certainty Consensus

Importance of OTC Derivatives. OTC derivatives are powerful tools that enable financial institutions, businesses, governmental entities, and other end users to manage the financial, commodity, credit and other risks that are inherent in their core economic activities. In this way, businesses and other end users of OTC derivatives are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both in the United States and abroad. Almost all OTC derivatives

transactions involve sophisticated counterparties, and, unlike the futures markets, there is virtually no “retail” market for these transactions.

The use of OTC derivatives is a positive force in the financial markets. As Federal Reserve Chairman Greenspan noted at a Senate Banking Committee hearing (March 7, 2002) “they (derivatives) are a major contributor to the flexibility and resiliency of our financial system. Because remember what derivatives do. They shift risk from those who are undesirous or incapable of absorbing it to those who are.” OTC derivatives are used to unbundle risks and transfer those risks to parties that are able and willing to accept them. For example, if a corporation has floating rate debt outstanding and is concerned that interest rates might rise, it could use an interest rate swap to effectively convert its debt into a fixed rate obligation, thereby fixing its exposure. Similarly, if business has the right to receive non-dollar denominated revenues from a foreign-based affiliate, it could use a currency swap to hedge the risk of exposure to fluctuating exchange rates.

OTC derivatives transactions can be custom tailored to meet the unique needs of individual firms. Due to the tailored nature of such transactions and their bilateral nature, and other factors, OTC derivatives differ substantially from the standardized exchange-traded futures contracts regulated by the CFTC. In a typical OTC derivatives transaction, two counterparties enter into an agreement to exchange cash flows at periodic intervals during the term of the agreement. The cash flows are determined by applying a prearranged formula to the “notional” principal amount of the transaction. In most cases, such as interest rate swaps, this notional principal amount never changes hands and is merely used as a reference for calculating the cash flows. Almost any kind of OTC derivative can be created. The flexibility and benefits that these transactions provide have led to their dramatic growth. In addition to interest rate and currency transactions, commodity, equity, credit and other types of transactions are widely used. Transactions take place around the world, but the United States has been a leader in the development of OTC derivatives transactions, and American businesses were among the earliest to benefit from these risk management tools. The dramatic growth in the volume and

diversity of OTC derivatives transactions is the best evidence of their importance to, and acceptance by, end users.

While its use is a matter of choice among the parties to the transaction, almost all OTC derivatives contracts both within and outside the United States are based on a Master Agreement published by ISDA. The ISDA Master Agreement is a standard form and governs the legal and credit relationship between counterparties, and incorporates counterparty risk mitigation practices such as netting and allows for collateralization. The ISDA Master Agreement also addresses issues related to bankruptcy and insolvency, such as netting, valuation and payment. The strength of the ISDA documentation and the important actions taken by Congress (and regulators) to ensure that OTC derivatives contracts would be enforceable in accordance with their terms have contributed positively to the ability of the financial and commodity markets to absorb events such as the Enron bankruptcy without systemic risk.

Legal Certainty and the CEA. The availability of OTC derivatives transactions within a strong legal framework is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management benefits that OTC derivatives transactions provide. One of ISDA's principal goals since its inception has been to promote legal certainty for OTC derivatives transactions.

"Legal certainty" simply means that parties must be certain that the provisions of their OTC derivatives contracts will be enforceable in accordance with their terms. For example, ISDA has sought to establish (i) clarity concerning how OTC derivatives transactions will be treated under the laws and regulations of the United States as well as many other countries; (ii) certainty that OTC derivatives transactions will be legally enforceable in accordance with their terms and not subject to avoidance; and (iii) certainty that key provisions of OTC derivatives transactions (including netting and termination provisions) will be enforceable, even in the case of the bankruptcy of one of the parties. Within the United States, until the adoption of the CFMA, the CEA was the

major source of legal uncertainty with respect to OTC derivatives. As discussed below, both Congress and the CFTC have since the late 1980s acted to provide increased legal certainty for OTC derivatives.

The original version of what is now the CEA was enacted in 1922 to ensure that participants in the commodities futures markets were not defrauded and that those markets, which served significant price discovery functions, were not manipulated. To achieve these objectives, the CEA required, and still requires, that all futures contracts on covered commodities be traded on a government-regulated futures exchange. Under this “exchange-trading requirement”, all futures contracts that are not traded on a regulated futures exchange are illegal and unenforceable.

As originally enacted, the CEA applied only with respect to certain agricultural commodities. In 1974, the CEA was substantially revised by (i) establishing the CFTC as an independent agency to administer the CEA; (ii) expanding the definition of “commodity” to include (with certain exceptions) “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with”; and (iii) at the request of the Treasury Department, providing a statutory exclusion from the CEA for transactions in or involving government securities, foreign currencies and certain other similar commodities.

1989 Swaps Policy Statement. In the late 1980s, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At this time, there was a consensus that OTC derivatives were not “futures” contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA’s exchange trading requirement.

To address these concerns, the CFTC issued a Swaps Policy Statement in 1989 stating its view “. . . that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the CEA. . . .” The CFTC also established a nonexclusive safe harbor for swaps transactions that met certain requirements (e.g., that they were undertaken in connection with a line of

business and not marketed to the general public). The Swaps Policy Statement provided legal certainty that the CFTC would not initiate enforcement actions with respect to OTC derivatives that satisfied the safe harbor, but it did not and could not eliminate the risk that a counterparty to an OTC derivatives contract would attempt to avoid its contractual obligations by seeking a court ruling that the contract was an illegal off-exchange “futures” contract.

Futures Trading Practices Act of 1992 (FTPA). In 1992, Congress itself took a crucial step to provide legal certainty that the CEA was not applicable to OTC derivatives by passing the FTPA. In this important legislation Congress provided the CFTC with explicit statutory authority to issue exemptions from the CEA. The purpose of granting this exemptive authority was “. . . to give the [CFTC] a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner.”

In passing the FTPA, Congress specifically directed the CFTC to resolve legal certainty concerns with respect to OTC derivatives by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that any class of OTC derivatives transactions were “futures,” the Congress made it very clear that granting of an exemption does not “. . . require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the [CEA].”

1993 CFTC Exemptions. In response to the FTPA, the CFTC adopted a series of exemptions. In January 1993, the CFTC issued the Swaps Exemption and an exemption for hybrid instruments. The Swaps Exemption exempted certain types of OTC derivatives, when entered into between sophisticated counterparties, from most provisions of the CEA, including the exchange-trading requirement. In general, the Swaps Exemption covered a broader range of contracts than did the 1989 Swaps Policy Statement, but some types of OTC derivatives were not covered (e.g., other provisions of the CEA precluded application of the Swaps Exemption to OTC derivatives based on securities). In April 1993, the CFTC also issued an exemption for certain contracts involving specified energy products when entered into between commercial participants.

This exemption, issued after notice and opportunity for public comment, was also intended to provide legal certainty that the covered energy contracts were not subject to regulation under the CEA.

1998 CFTC Concept Release and Congressional Moratorium. Despite these efforts by Congress and the CFTC to provide increased legal certainty that most OTC derivatives were not appropriately regulated as futures under the CEA, concerns continued to exist. These concerns proved to be neither academic nor speculative. In 1998, the CFTC issued a so-called “Concept Release” on OTC derivatives. As described by this Committee, the Concept Release

“... was perceived by many as foreshadowing possible regulation of these instruments [OTC derivatives] as futures. The possibility of regulatory action had considerable ramifications, given the size and importance of the OTC market. This action [by the CFTC] significantly magnified the long-standing legal uncertainty surrounding these instruments, raising concerns in the OTC market, including suggestions it would cause portions of the market to move overseas.

“This prospect led the Treasury, the Fed and the SEC to oppose the concept release and request that Congress enact a moratorium on the CFTC’s ability to regulate these instruments until after the [President’s] Working Group [on Financial Markets] could complete a study of the issue. As a result, Congress passed a six-month moratorium on the CFTC’s ability to regulate OTC derivatives.” S. Rep. No. 103-390 (2000).

1999 President’s Working Group Report. On November 15, 1999, the President’s Working Group on Financial Markets issued its report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*. The Report reflected an extraordinary consensus reached by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. It recommended that Congress enact legislation explicitly to clarify that most OTC derivatives transactions involving

financial commodities generally are excluded from the CEA. As stated in the Report, “. . . an environment of legal certainty . . . will help reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector”. Indeed, as the Report also noted, the failure to enact such legislation “. . . would perpetuate legal uncertainty and impose unnecessary regulatory burdens and constraints upon the development of these markets within the United States.”

Commodity Futures Modernization Act of 2000 (CFMA). In December 2000, Congress passed the CFMA. This specific legislation was the product of more than two years of consideration. Four Committees of the Congress held hearings on and formally approved the legislation. At these hearings and elsewhere, key financial regulators (the Treasury, the Federal Reserve, the SEC and the CFTC) and other interested parties presented and debated the merits of various alternative proposals. At each stage of its consideration, bipartisan majorities approved the CFMA.

The principal purpose of the legislation was to eliminate, and not merely reduce, uncertainty with respect to the legal and regulatory status of most OTC derivatives transactions involving sophisticated counterparties. In this respect, as demonstrated by the preceding discussion, the CFMA did not mark a radical departure from prior policy. For more than a decade prior to passage of the CFMA, Congress and the CFTC had worked diligently and almost without exception to provide increased legal certainty that OTC derivatives transactions were not appropriately regulated as futures contracts under the CEA. The CFMA was therefore a culmination of a long and deliberate process to provide legal certainty for OTC derivatives and thereby reduce systemic risk and promote financial innovation.

IV.

Experience Under the CFMA

Our experience to date under the CFMA indicates that Congress did indeed achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that would both reduce systemic risk and promote financial innovation. As noted above, the increased use of interest rate, foreign currency and credit derivatives has enabled American businesses and financial institutions to manage these

key financial risks more effectively during the current economic downturn than would have otherwise been possible. In addition, the development of new types of OTC derivatives to manage other types of risks, as well as the emergence of clearing proposals, is evidence that the CFMA has created a climate that fosters financial innovation.

Equally significant, three events since the passage of the CFMA have in many ways “stress tested” the OTC derivatives markets and the applicable provisions of the CFMA itself. The results have been encouraging. First, there is no question but that the CFMA structure enabled firms to deal with the economic downturn in the early part of this decade in a more effective manner. The well publicized events leading to Enron’s bankruptcy filing in December 2001 presented a second test. Enron raised serious concerns involving accounting practices, securities law disclosures and corporate governance policies. These issues received serious attention from policymakers and the Enron situation contributed to the decision of Congress to enact the Sarbanes-Oxley Act of 2002. Moreover, the CFTC and other regulators conducted intensive investigations (some of which are ongoing) and initiated a broad range of enforcement actions, including actions based on the CFMA.

ISDA also carefully considered the possible implication of the Enron collapse. In a detailed study entitled “Enron: Corporate Failure, Market Success,” released in April 2002 (available on ISDA’s web site), ISDA concluded that OTC derivatives did not cause, or contribute materially to, Enron’s failure. Had Enron complied with accounting and disclosure requirements, it could not have built the “house of cards” that eventually led to its downfall. The market in the end exercised the ultimate sanction over Enron and the market for swaps and other OTC derivatives worked as expected and experienced no apparent disruption. The OTC derivative market did not fail to function in the Enron episode. Indeed, market participants have learned much about risk management in recent years. Considering the size of Enron, it is important to note that its failure did not have a systemic impact.

The equally well-publicized transactions of Enron and others in or with respect to the California energy market presented a third test involving different public policy questions; namely, the design of the California electricity market, the lack of adequate

reserves, demand response relative to growing electricity demand and possible manipulation of the wholesale market. ISDA views any credible allegations of “manipulation” in financial or other markets as a serious matter requiring attention and therefore welcomed the investigations by the appropriate federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC) and the Department of Justice. Both FERC and the CFTC have now initiated a series of enforcement actions employing the tools available under existing law, including the CFMA. Based on this experience, there does not appear to be any specific evidence that the Commission’s antimanipulation authority is deficient.

In 2003, ISDA released a white paper entitled “Restoring Confidence in the U.S. events that led to the loss of confidence in these markets, the paper identified the regulatory framework (as enhanced by the CFMA) as one of the factors that was effective in countering the fallout from market events. As in the case of the Enron bankruptcy, the CFMA contributed to the ability of the markets to respond to a difficult situation with potentially broad ranging impact.

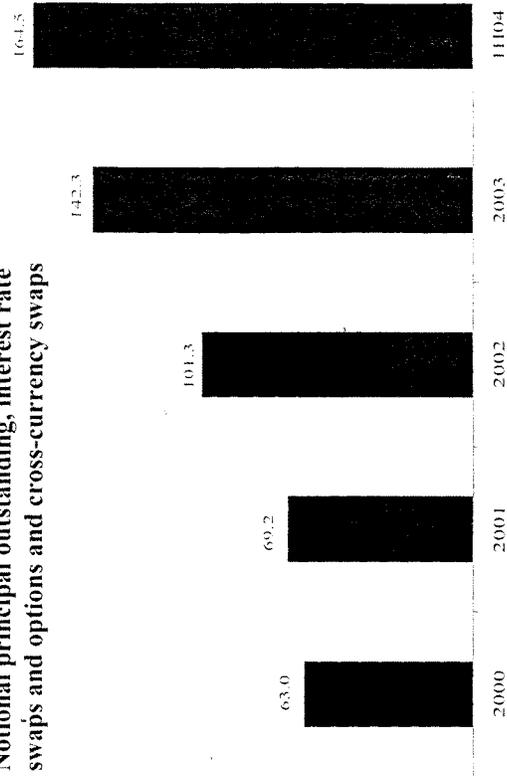
IV.

Conclusion

OTC derivatives are a considerable contributor to the flexibility and resiliency of our financial system. They allow businesses, financial institutions, governmental entities and other end users to manage the financial, commodity, credit and other risks inherent in their core economic activities in an efficient manner. The CFMA provide legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts. This policy, now codified in the CFMA, materially reduces systemic risk and encourages financial innovation. The economic downturn at the beginning of this decade, and the manner in which the OTC derivatives markets functioned in the case of the collapse of Enron and the California energy market situation, have, together with the enforcement actions of the CFTC under the CFMA, confirmed that the policy judgments Congress made in 2000 were sound then and remain so today.

Derivatives growth, 2000-2004

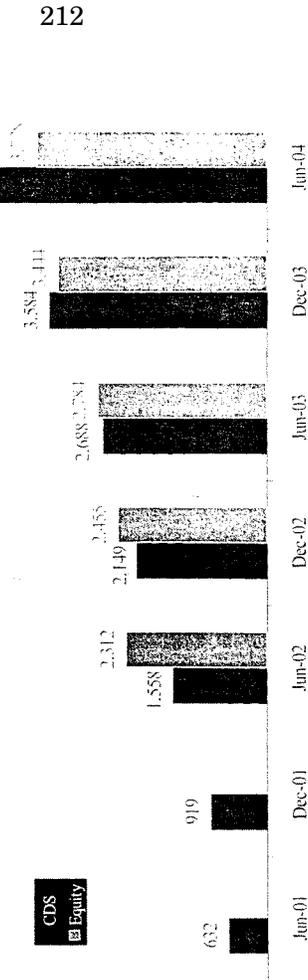
Notional principal outstanding, interest rate swaps and options and cross-currency swaps



Source: International Swaps and Derivatives Association

Credit default swaps and equity derivatives

Equity derivatives include equity forwards, swaps, and privately negotiated (OTC) equity options



Source: International Swaps and Derivatives Association

**TESTIMONY OF DANIEL J. ROTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION**

**BEFORE THE SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES**

MARCH 9, 2005

My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Moran and members of the Subcommittee for this opportunity to appear here today to present our views on some of the issues facing Congress as it begins the reauthorization process. NFA is the industry-wide self-regulatory organization for the U.S. futures industry. Regulation is all we do at NFA—we do not operate a marketplace and we are not a lobbying organization. As a regulator, NFA is first and foremost a customer protection organization. Our mission is to provide the futures industry with the most effective and the most efficient regulation possible.

Our approximately 4,000 Members include futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). We also regulate approximately 54,000 registered account executives who work for our Members. As a regulator, NFA's main responsibilities are many and varied. We establish rules and standards to ensure fair dealing with customers; we perform audits and examinations of our Members to monitor their compliance with those rules; we conduct financial surveillance to enforce compliance with NFA financial requirements; we provide arbitration and mediation of futures-related disputes; we perform trade practice and market surveillance activities for a number of exchanges; and we conduct extensive educational programs both for the investing public and for our Members. We also perform a number of regulatory functions on behalf of the CFTC, including the entire registration process—from screening applicants for fitness to taking actions to deny or revoke registrations when those fitness standards are not met. We perform these duties with a staff of approximately 235 people and a budget of over \$32 million, all of which is paid by the futures industry.

The process of self-regulation has been the subject of a great deal of criticism over the last several years. The problems in the securities industry have been well publicized to say the least and have led some, including New York Attorney General Elliot Spitzer, to label self-regulation "an abysmal failure." Less well publicized is the tremendous track record that self-regulation has achieved in the U.S. futures industry. Since NFA began operations in 1982, volume on U.S. futures markets has increased by over 1,200%—a great testament to the innovation and value of our futures markets. What most people don't realize is that during that same time period customer

complaints in the futures industry are down by almost 75%. In 1982 the CFTC received over 1,000 customer complaints in its reparations program. Last calendar year the CFTC received just 93 complaints. Even when you add the 158 cases filed with NFA's arbitration program, the reduction in customer complaints is dramatic.

That dramatic drop was not an accident. NFA has worked in very close partnership with the CFTC and the futures exchanges to make sure that we are allocating resources where they are most needed, that we do not duplicate each other's efforts and that precious regulatory resources are not squandered. Self-regulation, both by NFA and the futures exchanges, has served this industry very well for a very long time. That's not to say that any of us can rest on our laurels or that the self-regulatory process is perfect.

Obviously, the industry is changing rapidly, and as it changes, the conflicts of interest inherent in the self-regulatory process may change as well. As futures markets all over the world grow more and more competitive, the need to ensure that the self-regulatory process remains above the competitive fray grows too. The CFTC's job of overseeing the self-regulatory process may become more sensitive and more complicated. We have every confidence, though, that the CFTC will continue to monitor self-regulation carefully so that self-regulation in the futures industry will continue to merit the confidence that it has earned.

In the last reauthorization process, Congress made bold changes to the Commodity Exchange Act. The Commodity Futures Modernization Act rejected a highly prescriptive, outmoded approach to regulation in favor of a more flexible approach that focused regulatory protections where they were most needed. I am pleased to join the rest of the industry in noting the great success of the CFMA and the superb work of the CFTC in implementing exactly the kind of flexible regulatory approach that the CFMA envisioned. The Commission and its staff have worked to reduce unnecessary and costly regulatory burdens for every segment of the industry while preserving the highest level of customer protection. The Commission has also followed the mandate of the CFMA to maximize efficiency by delegating more day-to-day, front line regulatory responsibilities to NFA. In January 2003, the Commission delegated to NFA the authority to conduct reviews and analyses of annual financial reports filed by CPOs. Additionally, in March 2003, the CFTC authorized NFA to conduct reviews of disclosure documents for publicly-offered commodity pools. Each of these recent delegations has been performed by NFA in a high-quality and expeditious manner. In making these delegations, the Commission has been able to free up its own valuable resources to apply them to areas demanding attention.

Though the CFMA has been a great success, it failed in one of its objectives that directly impacts customer protection. In the CFMA Congress attempted to resolve the so-called Treasury Amendment issue once and for all by clarifying that the CFTC does, in fact, have jurisdiction to protect retail customers investing in foreign currency futures. The basic thrust of the CFMA in this area was that foreign currency futures with retail customers were covered by the Act unless the counterparty was an

"otherwise regulated entity," such as a bank, a broker-dealer or an FCM. Unfortunately, as we sit here today, there is as much uncertainty over the CFTC's authority to protect retail customers as there was five years ago. This uncertainty is clearly not what Congress intended in passing the CFMA.

The main problem stems from a decision in the Seventh Circuit Court of Appeals in a forex fraud case brought by the CFTC, the so-called Zelener case. In Zelener, the District Court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures. The Seventh Circuit affirmed that decision. The "rolling spot" contracts in Zelener were marketed to retail customers for purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In Zelener, though, the Seventh Circuit based its decision that these were not futures contracts exclusively on the terms of the written contract itself. Because the written contract in Zelener did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures.

Zelener creates the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals can sell retail customers contracts that look like futures, act like futures and are sold like futures and can do so outside the CFTC's jurisdiction. To make matters worse, the rationale of the Zelener decision is not limited to foreign currency products. Similar contracts for unleaded gas, heating oil, agricultural products or virtually any other commodity could be sold to the public in an unregulated environment.

I recognize that Zelener is just one case, and we should not overreact to it. It's true that the Zelener decision would allow the CFTC in other cases to present evidence that the FCM made oral representations about the customer's right to offset. But the reality is that in most cases the sales pitch is not made by the FCM but by an unregistered, unregulated solicitor. It's not clear to me that any court would find that the nature of the contract between the customer and the FCM was transformed into a futures contract because of oral representations made by some third party. In my opinion, trying to work our way out of the Zelener problem through future enforcement actions puts an awful lot of chips on a bet that's no sure thing.

The bottom line is that the Zelener decision makes it much harder for the Commission to prove that contracts sold to retail customers to speculate in commodity prices are futures, makes it easier for the unscrupulous to avoid CFTC regulation and creates a real, live customer protection issue. Unsophisticated retail customers are going to be victimized by high-pressured sales pitches for futures look-alike products covering everything from foreign currencies to precious metals to heating oil and to any other commodity known to man. These retail customers are the ones who most need regulatory protection and that protection should not be stripped from them because a clever lawyer finds a loophole in the law.

It's NFA's view that Congress should address this issue. It may not be easy. The issues can be both sensitive and complex. We would want to ensure that any legislative response would not have unintended consequences. But just because it's hard doesn't mean that it can't be done. We recognize that this Subcommittee has asked the CFTC to submit specific statutory language to address this issue. NFA is working closely with the Commission and the industry to develop a specific proposal for your consideration.

Unfortunately, the Zelener decision is not the only problem we have encountered with retail forex. Since passage of the CFMA, a number of firms—that do not engage in any other regulated business—have nonetheless registered as FCMs to qualify to be an otherwise regulated entity and have become NFA Forex Dealer Members for the sole purpose of acting as counterparties in these transactions. When I testified before this Subcommittee in June 2003, NFA had 14 active Forex Dealer Members and those Members held approximately \$170 million in retail customer funds. During the last eighteen months, this retail forex business has continued to grow by leaps and bounds. Today, NFA has 28 active Forex Dealer Members holding over \$520 million in customer funds. That growth has not been problem free.

Though relatively few in number, forex dealers have accounted for 50% of our emergency enforcement actions and over 20% of our arbitration docket. I know the CFTC has been very aggressive in enforcement cases involving forex, though most of those cases have involved unregistered firms. Obviously, retail forex has consumed a good deal of resources at NFA, but we are committed to doing whatever it takes to get our job done. We have appointed a blue ribbon committee to review all of our forex rules. Just two weeks ago, our Board passed additional rules to strengthen both our financial requirements and sales practice rules regarding forex. We will continue to enforce our rules vigorously and bring actions whenever necessary to ensure compliance with our rules. Part of the problem, though, is that some firms can operate beyond our reach, in a completely unregulated environment because of a glitch in the wording of the CFMA.

As I mentioned before, the basic thrust of the CFMA was that only "otherwise regulated entities" could offer retail customers off-exchange foreign currency futures. Unfortunately, the wording of the statute only requires the counterparty to be an otherwise regulated entity. This creates the possibility that an FCM, for example, might be the counterparty but the firm that actually does the telemarketing for these products is completely unregistered and unregulated. There are literally hundreds of these unregulated firms doing telemarketing of off-exchange forex transactions to retail customers and in some instances the people making the sales pitches have been barred from the futures industry for sales practice fraud. I don't think that's what Congress intended at all and NFA would support an amendment to Section 2(c) of the Act to make clear that not only the counterparties but also the persons actually selling these products to retail customers must be "otherwise regulated entities."

There's one more forex problem I should mention, though we are hopeful that it's a problem we can solve through NFA rules without any further legislation from Congress. Section 2(c) of the CEA could be read to allow unregulated affiliates of FCMs to act as counterparties to retail customers if the FCM makes and keeps records of the affiliates under the CEA's risk-assessment provisions. Some firms have tried to take advantage of this provision of the Act by creating "shell" FCMs. These shell FCMs do not do any futures business and they do not do any retail forex business. Their sole reason for existence seems to be to create affiliates that do retail forex business in a completely unregulated environment.

I don't think that that's what Congress had in mind. Neither does the CFTC. The Commission has a pending enforcement action against one affiliate in which it alleges, among other things, that the affiliate does not qualify under the CFTC's risk-assessment provisions. A ruling in the CFTC's favor would, in part, require FCMs with retail forex affiliates to maintain \$5 million in adjusted net capital. However, since that case may take some time to work its way through the federal court system, NFA's Board recently adopted a rule raising the minimum capital requirement for FCMs with retail forex affiliates from \$250,000 to \$5 million. We hope these efforts will solve the shell FCM problem without the need for legislative relief.

Another issue that Congress should be aware of, though we are not seeking amendments to the Act, involves the SEC's recent rulemaking that requires advisors of certain hedge funds to register under the Investment Advisers Act of 1940. Coordination among regulators has always been vital to avoid duplication of effort and the squandering of regulatory resources. With the SEC rulemaking, there's a real danger of duplication of effort regarding the CPOs and CTAs that are already regulated by the CFTC and NFA. Such duplication drains regulatory resources that are already oftentimes stretched too thin.

According to recent rankings by *Institutional Investor*, eighteen of the top 25 and 63 of the top 100 hedge fund complexes are operated by NFA Member CPOs or their affiliates. In fact, most of the prominent names in the hedge fund business are NFA Members. NFA already has extensive regulatory programs in place for all of its CPO and CTA Members, including regular audits and review of financial statements, disclosure documents and promotional material. Though we focus on futures-related activity, our review of our CPO financial records includes information on non-futures related investments. Overall, the CFTC/NFA regulation of CPOs and CTAs has been an unqualified success. CPOs and CTAs comprise 60% of NFA's membership but are named in only 20% of NFA's enforcement actions and in only 2% of customer complaints. If the SEC, the CFTC and NFA all end up regulating some of the same funds, that doesn't seem to be the smartest use of regulatory resources. We hope the CFTC and the SEC can work together to make the regulatory process as efficient as possible and we will do everything we can to help that process. Frankly, however, given our experience with security futures products, we are skeptical that regulatory efficiency can be achieved through cooperation between these agencies. We urge this Subcommittee to use its oversight function to ensure that cooperation occurs, and if you

are not satisfied with the level of cooperation, then we encourage you to consider a legislative response to this issue. We, of course, are willing to work with you in developing such a response if necessary.

One more area in which we can avoid duplication of effort would require Congressional action. The Act requires the CFTC to operate a reparations program to handle the resolution of disputes between customers and CFTC registrants. The program made a lot of sense when it was established almost 30 years ago, but the world is a much different place now. The CFTC and NFA have cracked down on sales practice fraud and NFA's arbitration program has grown and matured as an informal alternative to reparations. The impact of all these changes on the reparations program has been dramatic. In 1982, before NFA began operations, there were 1,079 cases filed with the Commission. As previously noted, last calendar year there were 93, compared with 158 arbitration cases filed at NFA. Simply stated, the reparations program has outlived its usefulness and we see no reason why the CFTC should be the only federal regulatory agency that maintains a dispute resolution forum. NFA would support an amendment to the Act to eliminate the reparations program.

In closing, let me state that NFA believes the industry and the public have benefited greatly from the enlightened regulatory approach that Congress adopted in the CFMA. We are proud of the efficiency we have brought to the regulatory process and are confident that the amendments we suggest above will further improve both customer protection and regulatory efficiency. We look forward to working with this Subcommittee and with the industry to address the issues outlined above.

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

Before the
SUBCOMMITTEE ON GENERAL FARM COMMODITIES & RISK MANAGEMENT
HOUSE COMMITTEE ON AGRICULTURE
March 9, 2005

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

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

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

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

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

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

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

guessing exchange decisions.

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

Market Participants

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

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

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

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

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

Trade Matching, Monitoring and Clearing

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

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

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

Exchange Governance

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

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

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

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

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

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

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

Disciplinary Procedures

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

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

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

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

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

Conflicts of Interest

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

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

Challenges and Opportunities

Protection of Market Data Rights

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

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

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

Warehouse Act of 2002 Creates New Opportunity

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

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

Connecting with Customers

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

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

Looking Forward

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

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

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

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

**SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND
RISK MANAGEMENT COMMITTEE ON AGRICULTURE**

**TESTIMONY OF JEFFREY C. SPRECHER
CHAIRMAN AND CEO
INTERCONTINENTAL EXCHANGE, INC.**

MARCH 9, 2005

Mr. Chairman and Members of the Subcommittee, I am pleased to testify today. My name is Jeffrey C. Sprecher and I am the founder, Chief Executive Officer and Chairman of IntercontinentalExchange, Inc. (ICE). ICE operates the leading global electronic over-the-counter, or OTC, marketplace for trading energy commodities and derivative contracts based on energy commodities. ICE's leading Internet-based electronic platform brings together buyers and sellers of energy commodities and OTC derivative energy contracts. ICE also operates an energy futures exchange through its wholly-owned U.K. subsidiary, the International Petroleum Exchange, or the IPE.

I would like to thank the Committee for its effective and far-sighted work in developing and adopting the Commodity Futures Modernization Act of 2000 (CFMA). Among its many achievements, the CFMA provided for a new category of trading facility, the exempt commercial market, or ECM. This Committee recognized that electronic marketplaces whose participants are limited to eligible commercial entities trading on a principal-to-principal basis do not require the same level of federal oversight as futures exchanges that are accessible by the general public. ICE operates as an ECM today because of the good work of this Committee in adopting the CFMA.

I. ICE OVERVIEW

Headquartered in Atlanta, Georgia, ICE was formed in 2000 pursuant to a no-action letter from the Commodity Futures Trading Commission (CFTC), the terms of which were later that year substantially codified in the CFMA. ICE operates a "many-to-many" electronic platform that allows buyers and sellers of derivative energy contracts and physical commodities to view and act upon each other's bids and offers. ICE's electronic platform automatically matches buyers and sellers posting the best bids and offers according to a neutral "first-in, first out" algorithm, thereby ensuring a level playing field for both the largest and smallest of its market participants. ICE itself is not a party to any of the transactions on its platform and does not participate as a principal in the markets for energy commodities trading in any forum.

ICE's electronic marketplace is globally accessible, promotes price transparency and offers participants the opportunity to trade a variety of energy products. Its key products include energy derivative contracts for crude oil, natural gas and power. Among other things, its products provide market participants with a means for managing risks associated with changes in the prices of energy commodities, ensuring physical delivery of energy commodities, and the ability to obtain exposure to energy commodities as an asset class. The majority of ICE's energy contracts are financially settled, meaning that payment is made through cash payments based on the value of the underlying commodity rather than by actual delivery of the commodity itself.

ICE's electronic platform is designed to enhance the speed and quality of trade execution. In addition, its platform offers a comprehensive suite of trading-related services,

including OTC electronic trade confirmation and access to clearing services. ICE also offers a variety of market data and information services.

ICE operates its OTC business through its globally accessible electronic platform, and offers trading in a wide variety of OTC energy contracts. ICE's customers, representing many of the world's largest energy companies and leading financial institutions, as well as proprietary trading firms, natural gas distribution companies and utilities, rely on its platform for price discovery, hedging and risk management. As of the end of 2004, ICE had over 5,000 screens at over 860 participant trading firms, and on a typical trading day over 3,600 individual screen users are connected to its platform for trading. OTC contracts available for trading on its electronic platform include forwards, options, swaps, differentials and spreads. ICE introduces trading in additional, complimentary products on its electronic platform on a regular basis, leveraging the scalable and flexible nature of its platform. We believe that ICE has enhanced the ability of market participants to access and utilize the energy markets by creating more competition through an innovative trading mechanism and complete transparency of prices and transactions. These factors, in our view, have allowed participants to trade more efficiently and effectively, which also serves the larger public interest.

A. Trade Execution Services

Participants executing trades on the ICE platform can take advantage of a broad range of automated OTC trade execution services, including straight-through trade processing and electronic trade confirmation. Prior to the commencement of trading on ICE, virtually all OTC energy derivatives trading was conducted either directly between two counterparties, or through "voice brokers," which matched buyers and sellers through telephone conversations. These mechanisms, however, are cumbersome and inefficient and do not allow market

participants to find the opposite side of a desired transaction quickly or cheaply. Moreover, pricing in these markets was completely opaque, with no centralized location to capture bids, offers or transaction prices. ICE has transformed these markets by providing OTC market participants with the ability to view bids, offers and transactions on a completely transparent basis and to execute transactions quickly and efficiently by a click on a computer screen.

eConfirm is ICE's electronic trade confirmation system. eConfirm offers market participants an automated, reliable, and low-cost alternative to manual trade verification and confirmation. eConfirm reviews electronic trade data received from individual traders, screens and matches this data electronically, then highlights any discrepancies in a report to the traders' respective back offices. In doing so, it significantly decreases the risk of "confirmation errors" and dramatically reduces the recordkeeping burden on companies by feeding directly into the risk management and recordkeeping systems of companies. eConfirm is available for use by both ICE market participants and OTC market participants who trade through voice brokers or other means.

B. Centralized Clearing Services

ICE's most actively traded and liquid OTC markets include those with contracts that can be traded bilaterally or cleared at the customer's option. In order to provide participants with access to centralized clearing and settlement, ICE launched the industry's first cleared OTC natural gas and oil contracts in March 2002, and introduced the first cleared OTC power contracts in December 2003. In a cleared OTC transaction, our clearing services provider, LCH.Clearnet, acts as the counterparty for each clearing member that is a party to the transaction (with each clearing member in turn acting on behalf of its customer), thereby reducing the credit risk that would otherwise be presented by a traditional principal-to-principal OTC transaction.

Participants who are comfortable with the credit of their counterparty may prefer to trade on a bilateral basis. The introduction of cleared OTC contracts has provided participants with an important alternative to bilateral clearing, by reducing the amount of collateral participants are required to post on each OTC trade, as well as the resources required to enter into multiple negotiated bilateral settlement agreements to enable trading with other counterparties. In addition, the availability of clearing through LCH.Clearnet for both ICE's OTC transactions and futures trades conducted through the IPE enables participants to cross-margin certain of their futures and OTC positions, meaning that a customer's position in its futures and OTC trades can be offset against each other, thereby reducing the total amount of collateral a customer must deposit with LCH.Clearnet.

The availability of clearing services and the attendant improved capital efficiency has attracted new participants to the market for energy commodities trading. The growing number and type of participants trading on ICE's platform has increased liquidity as well as the volume of gas, power and oil contracts traded. There are 23 futures commission merchants (FCMs) clearing transactions for the approximately 1,200 participants active in ICE's cleared OTC markets. As of February 2005, open interest in ICE's cleared OTC contracts was approximately one million contracts in gas, power and oil.

C. Market Data

ICE also serves the market data needs of its participants and the broader marketplace through the 10x Group, ICE's market data subsidiary. Established in 2002 in response to growing demand for objective, transparent and verifiable energy market data, 10x generates market information and indices based solely upon auditable transaction data derived from actual OTC trades executed on ICE's electronic platform and/or confirmed through ICE's

eConfirm. Each trading day, 10x delivers proprietary energy market data directly from ICE's OTC market to the desktops of thousands of market participants. 10x publishes ICE Daily Indices for OTC natural gas and power contracts for 60 of the most active natural gas hubs and 30 of the most active power hubs in North America. 10x was recently recognized by the Federal Energy Regulatory Commission (FERC) as the only publisher of natural gas and power indices to fully comply with all of the gas and power index publishing standards identified in the FERC Policy Statement of Price Indices. 10x transmits the ICE Daily Indices via e-mail to 7,100 energy industry participants each trading day. 10x also provides an End of Day Report which is a comprehensive electronic summary of daily trading activity on ICE's electronic platform. ICE's operations generate an increasingly broad range of market data, which is distributed on a real-time and historical basis.

D. IPE

ICE's wholly-owned subsidiary, the IPE, operates as a Recognized Investment Exchange in the United Kingdom and is the second largest energy futures exchange in the world. All IPE futures and options trades are executed either on the open-outcry exchange floor or on ICE's electronic platform and, in either case, all transactions are cleared by LCH.Clearnet. On March 7, 2005, IPE announced that it will be closing the open-outcry trading floor and transitioning to conducting trading exclusively on ICE's electronic platform. IPE members and their customers include many of the world's largest energy companies and leading financial institutions. IPE offers trading in the IPE Brent Crude futures contract, a benchmark contract relied upon by many large oil producing nations to price their oil production. IPE also trades other futures contracts, including gasoil and other energy products.

II. CFTC OVERSIGHT OF ICE

Pursuant to the terms of the CFMA and regulations adopted by the CFTC to implement the CFMA, ICE operates its OTC electronic platform as an ECM. The CFMA and CFTC regulations require that all ICE participants must qualify as eligible commercial entities, as defined by the CFMA, and that each participant trade for its own account, as a principal. Eligible commercial entities include entities with at least \$10 million in assets that incur risks (other than price risks) relating to a particular commodity or have a demonstrable ability to make or take delivery of that commodity, as well as entities that regularly purchase or sell commodities or related contracts and are part of a group with at least \$100 million in assets or assets under management. ICE has obtained orders from the CFTC permitting floor brokers and floor traders on U.S. and non-U.S. exchanges to be treated as eligible commercial entities, subject to their meeting certain requirements.

As an ECM, ICE is required to comply with access, reporting and record-keeping requirements of the CFTC. Both the CFTC and the FERC have view only access to ICE's trading screens on a real-time basis. In addition, ICE is required to report to the CFTC transactions in products that are subject to the CFTC's jurisdiction that meet certain volume requirements, and record and report to the CFTC complaints that ICE receives of alleged fraud or manipulative activity on its markets. ICE is also required under CFTC regulations to make available to the public, at no charge, delayed prices for any products on its OTC market that perform a price discovery function. While ICE is not substantively regulated in the same manner as the designated contract markets, it is subject to oversight by the CFTC. In contrast, "voice brokers" and other OTC market participants are not subject to CFTC jurisdiction in any respect.

ICE has worked closely with the CFTC to educate the agency about its functions as an ECM. It has actively responded to CFTC requests for information and has provided input on the public record as the CFTC has developed and revised rules for ECMs. ICE has developed a good working relationship with the CFTC and looks forward to continuing that cooperative relationship.

III. REAUTHORIZATION

We look forward to working with the Committee as it considers the many issues facing the CFTC during the reauthorization process. With respect to issues affecting ECMs in particular, ICE is of the view that the CFMA and the rules adopted by the CFTC provide an effective framework for oversight of these commercial marketplaces and that there is no need to amend the Commodity Exchange Act in this area. While ICE is aware that some have recommended increased regulation of exchange and OTC energy trading, ICE does not believe that additional market restrictions would be in the public interest or would achieve the goals outlined. Price volatility in the energy markets has a number of fundamental sources, such as geopolitical events, production and consumption cycles, supply and demand imbalances, delivery locations, and seasonality. These factors will be present, and will result in periods of price volatility, regardless of the type and level of regulation that is applied to the relevant markets. Accordingly, the goal, in our view, should be to enable market participants to access the tools that will allow them to deal most effectively with price volatility. We believe that open, freely accessible and transparent markets represent the best approach for addressing price volatility, and that Congress is to be commended for recognizing this and advancing these objectives through the creation of “exempt commercial markets” under the CFMA. Restricting

trading activity through additional regulation would only adversely affect market liquidity and price transparency and would not reduce volatility.

We also believe it is important to note that, as explained above, ICE matches buyers and sellers on its electronic platform, through the use of neutral algorithm, but does not itself become a party to any transaction as principal, nor does ICE otherwise trade in the energy markets. ICE's only role is to provide an impartial and independent venue in which market participants can view bids and offers and execute transactions. In contrast to the "one-to-many" platform operated by Enron, ICE's platform is a "many-to-many" system on which participants trade with each other, not with ICE. In fact, ECMs, by definition, are necessarily "many-to-many" facilities and do not present the issues and potential problems posed by platforms such as "Enron Online."

As reflected in ICE's own experiences, market liquidity and transparency that was adversely affected in 2001-2002 as a result of the reduction in trading by many merchant energy companies has now recovered. New market participants, including financial institutions and collective investment vehicles, have added new depth to the markets and have allowed markets to more rapidly achieve price levels determined by fundamental forces of supply and demand. Complaints about high energy prices and high price volatility are not properly directed to the exchange and OTC markets that provide robust opportunities for price discovery and transparency. ICE trusts that this Committee, with its long experience with trading markets, will recognize that there is no benefit in a "shoot-the-messenger" approach to regulation.

On behalf of ICE I would again like to thank this Committee for its excellent work in enacting the CFMA. It has been a clear benefit to our company and, I submit, to producers and users of energy commodities around the world. ICE looks forward to working

with this Committee as it tackles the many issues facing the CFTC during this reauthorization process. I stand ready to answer any questions that the Committee may have about ICE or the energy trading markets.

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MEMORANDUM FOR ISDA MEMBERS

COMMODITY FUTURES MODERNIZATION ACT OF 2000

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The Commodity Futures Modernization Act of 2000 (H.R. 5660) (the "Act") was signed into law by President Clinton on December 21, 2000.¹ The Act represents a sweeping overhaul of the provisions of the Commodity Exchange Act (the "CEA").

The Act addresses uncertainties regarding the status of over-the-counter ("OTC") derivatives and hybrid instruments under the CEA through a number of statutory exclusions and exemptions. The Act also addresses uncertainties regarding the status of certain non-retail swaps under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") by clarifying that while such swaps are not securities under those statutes, specific fraud, manipulation and insider trading prohibitions nevertheless apply to certain security-based swap agreements. This Memorandum will concentrate on the foregoing aspects of the Act.

The Act also restructures the regulation of exchange-traded futures contracts under the CEA. In addition, the Act permits, for the first time, the trading in the United States of futures contracts on individual equity securities and narrow groups and indices of such securities. Finally, the Act authorizes the clearing of OTC derivatives and establishes a framework for the regulation

¹ The Act was passed as part of H.R. 4577, the Consolidated Appropriations Act, 2001.

of clearing organizations. These aspects of the Act will be summarized at the end of this Memorandum.

The Commodities Futures Trading Commission (the "CFTC") approved rules consisting of four separate releases on November 22, 2000, that contained many provisions similar to the provisions of the Act. In a release issued on December 21, 2000, and effective as of December 28, 2000, the CFTC withdrew almost all the new rules as a result of the enactment of the Act.

I. Executive Summary

The key provisions of the Act from the point of view of OTC derivatives include the following:

1. Legal Certainty.

Concerns about the enforcement of OTC derivatives transactions due to the exchange-trading requirement of the CEA have been fully put to rest. Under the Act, no contract shall be unenforceable under the CEA or any other provision of Federal or State law based on a failure to comply with any exemption or exclusion from any provision of the CEA.

2. OTC Derivatives.

The Act excludes from the coverage of the CEA and regulation by the CFTC a broad range of swap agreements and

other OTC derivatives that are not executed on a trading facility.

- Transactions involving any commodity (other than an agricultural commodity) that are not executed on a trading facility are excluded from the CEA if they are entered into solely by eligible contract participants² and are subject to individual negotiation.
- Also excluded from the CEA are transactions involving "excluded commodities" (a broad range of interest rate, currency, credit, equity, weather and other derivatives, but not energy products, chemicals or metal derivatives) that are not executed on a trading facility and are entered into solely by eligible contract participants.
- Transactions involving "exempt commodities" (commodities other than excluded commodities or agricultural commodities, but including commodities such as energy products, chemicals and metals) are

² The Act's definition of "eligible contract participant" is based upon the CFTC's definition of "eligible swap participant" in the 1993 Swaps Exemption, but, as explained below, it has been expanded in several respects.

similarly excluded from the CEA, but remain subject to the CFTC's antifraud and antimanipulation jurisdiction.

The Act also provides exclusions for transactions entered into through electronic trading facilities.

- The Act excludes from the CEA any transaction involving an excluded commodity that is executed through an electronic trading facility by eligible contract participants trading on a principal-to-principal basis or by certain authorized fiduciaries or investment managers.
- The Act also provides an exclusion for any transaction involving an exempt commodity that is executed through an electronic trading facility by certain commercial entities trading on a principal-to-principal basis. Such transactions will be subject to the CFTC's antifraud and antimanipulation authority, and the facility will be subject to certain recordkeeping, price dissemination, reporting and related requirements.

In addition, the Act creates, as part of the separate "Legal Certainty for Bank Products Act of 2000", an exclusion from the CEA for certain individually negotiated

swap agreements offered by banks to eligible contract participants.

3. Hybrid Instruments.

The Act excludes from coverage of the CEA and regulation by the CFTC hybrid instruments that are "predominantly" securities. A hybrid instrument is "predominantly" a security for these purposes if the issuer receives full payment of the purchase price substantially contemporaneously with delivery, the holder is not required to make any additional payments to the issuer, the issuer is not subject to mark-to-market margining requirements and the instrument is not marketed as a futures contract (or option thereon).

The Act also adds, as part of the separate Legal Certainty for Bank Products Act of 2000, a parallel exclusion from the CEA for hybrid instruments that are predominantly identified banking products.

4. Treasury Amendment.

The Act amends the "Treasury Amendment" to exclude from the CEA transactions involving foreign currency, governmental securities, security warrants, security rights, resales of installment loan contracts, repurchase transactions in "excluded commodities" or mortgages or

mortgage purchase commitments that are not futures contracts (or options thereon) or commodity options conducted on "organized exchanges". An "organized exchange" is defined as a trading facility that permits trading by or on behalf of a person that is not an eligible contract participant or by persons other than on a principal-to-principal basis, or that has adopted rules that govern the conduct of certain participants and provide disciplinary sanctions.

The Act grants jurisdiction to the CFTC over foreign currency futures contracts or options (other than options traded on a national securities exchange) entered into with persons that are not "eligible contract participants", unless the relevant dealer is one of an enumerated group of regulated entities.

5. Treatment of Swaps under the Securities Laws.

The Act amends the 1933 Act and the 1934 Act to provide that swap agreements, whether or not based on securities prices, yields or volatilities, are not securities under those statutes.

- Swap agreement is defined broadly for this purpose with respect to transactions that are between eligible contract participants and the material economic terms of which are subject to individual negotiation.

- Swap agreements that are based on securities prices, yields or volatilities are, however, subject to specific antifraud, antimanipulation and anti-insider trading provisions of the 1933 Act and 1934 Act.
- The SEC nevertheless may neither require the registration of securities-based swap agreements nor promulgate or enforce rules or orders that impose reporting or recordkeeping requirements or other procedures or standards as prophylactic measures against fraud, manipulation or insider trading with respect to securities-based swap agreements.

6. Clearing.

The Act permits clearing of OTC derivatives transactions without disqualifying those transactions from any of the exclusions discussed above. The Act requires, however, that clearing of excluded OTC derivatives transactions occur through a clearing organization regulated by the SEC, the CFTC or the Federal banking regulators.

II. Background

The CEA was signed into law in 1974. Until amended by the Act, the CEA required that futures contracts be traded on a regulated exchange. A futures contract traded off an exchange was illegal and unenforceable. In

1974 this draconian standard was sensible because the meanings of "futures" and "exchanges" were reasonably clear in view of the types of transactions and trading systems in existence at that time. The development of OTC derivatives transactions since the early 1980's reduced this clarity and led to concerns about the enforceability of certain derivatives transactions under the CEA.

The CFTC mitigated this uncertainty when it issued the Swaps Policy Statement in 1989. The uncertainty was further reduced with the passage in late 1992 of the Futures Trading Practices Act and the related adoption by the CFTC of the Swaps Exemption in early 1993. Concerns about enforceability remained, however, because the Swaps Exemption does not apply to securities-based derivatives (e.g., equity derivatives and certain credit derivatives). This limitation in the Swaps Exemption was due to the express requirements of the Futures Trading Practices Act. The enhanced popularity of securities-based derivatives since 1993 has increased the uncertainty that remained after the adoption of the Swaps Exemption. Moreover, the terms of the Swaps Exemption have become less useful over time as derivatives activities have evolved since 1993.

Certain actions by the CFTC also increased legal certainty concerns. The enforcement orders of the CFTC involving Bankers Trust Company (December 22, 1994) and MG Refining and Marketing, Inc. (July 27, 1995) suggested that the CFTC believed that at least some OTC derivatives constitute "futures". In 1998, the CFTC issued a concept release regarding OTC derivatives that was perceived by many as a precursor to regulating these transactions as futures. This created both regulatory and enforceability uncertainty. Congress responded by adopting a six-month moratorium on the CFTC's ability to regulate OTC derivatives in order to give the President's Working Group on Financial Markets an opportunity to complete a study on the relevant issues. In November 1999 the President's Working Group completed its unanimous recommendations on OTC derivatives and presented its findings to Congress.³ Those recommendations provided the foundations for the Act.

There also has been uncertainty about the status of OTC derivatives under the 1933 Act and the 1934 Act. The

³ See Report of the President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act" (November 1999).

SEC's order imposing sanctions on Bankers Trust Company (December 22, 1994) used what many considered to be a broad definition of a "security" in order to assert regulatory jurisdiction in that situation. There also has been private litigation in the U.S. that has included broad assertions that OTC derivatives transactions constitute securities under the 1933 Act and the 1934 Act.

ISDA has been working to increase legal and regulatory certainty for OTC derivatives under the CEA since 1988. The passage of the Act represents the successful culmination of many years of work by ISDA and numerous other interested parties. It is also notable that the Act clarifies the status of OTC derivatives under the U.S. securities laws.

III. Definitions

Certain terms are fundamental to understanding the legal certainty provisions of the Act. A summary of the key terms is set forth below.

1. Agreements, Contracts or Transactions.

Numerous provisions of the Act apply to "agreements, contracts or transactions". The Swap Exemption adopted by the CFTC in 1993 applies to "swap agreements". Clearly, the new exclusions in the Act no longer require

that the subject transaction constitute a "swap agreement".

This change to a more generic term eliminates any suggestion that there is a separate requirement that a transaction meet some test of being a certain type of agreement before being excluded from the CEA. References to "any transaction" or "transactions" in this Memorandum should be understood as references to "any contract, agreement or transaction" or "contracts, agreements or transactions".

2. Eligible Contract Participant.

Several sections of the Act condition an exclusion or an exemption on the requirement that a transaction involve "eligible contract participants". The term "eligible contract participant" should include all derivatives dealers that are ISDA members and most of their counterparties. The term "eligible contract participant" is broader than "eligible swap participant" in the CFTC's 1993 Swaps Exemption in several respects. First, "eligible contract participant" includes natural persons with more than \$5,000,000 in assets who enter into the related transaction for risk management purposes. It also includes non-U.S. regulated insurance companies and regulated insurance company affiliates as well as non-U.S. banks and

their U.S. branches and agencies. Finally, "eligible contract participant" includes certain eligible contract participants acting as brokers, agents, investment advisors or fiduciaries. "Eligible contract participant" in relevant part includes:

(A) acting for its own account--

(1) a financial institution (any U.S. depository institution, any non-U.S. bank or U.S. branch or agency of a non-U.S. bank, any financial holding company or any trust company);

(2) an insurance company regulated by a State or subject to similar non-U.S. regulation, including regulated affiliates;

(3) a U.S. regulated investment company or a non-U.S. entity subject to similar regulation;

(4) a corporation, partnership or other entity that has total assets in excess of \$10,000,000;

(5) an ERISA employee benefits plan that has total assets in excess of \$5,000,000;

(6) a registered broker-dealer or a broker-dealer subject to similar non-U.S. regulation;

(7) an individual with total assets in excess of \$10,000,000 (or in excess of \$5,000,000 and who enters into the transaction for risk management purposes);⁴

(B) an eligible contract participant described in (a)(1), (2), (4) or (6) above or in (C) below when acting as a broker or performing a similar agency function on behalf of any other eligible contract participant; or

(C) a registered investment advisor, a registered commodity trading advisor (or, in either case, a non-U.S. person subject to similar regulation) or an eligible contract participant described in (A)(1), (2), (4) or (6) above when, acting as an authorized investment manager or fiduciary.

The distinction made in (B) and (C) above is relevant to the exclusion for transactions in an excluded commodity executed on an electronic trading facility in new

⁴ The definition of "eligible contract participant" also covers material associated persons of broker-dealers, futures commission merchants, floor brokers, floor traders, governmental entities and commodity pools.

Section 2(d)(2) of the CEA, which is available if the transaction either is entered into on a principal-to-principal basis or as described in (C) above (but not in (B) above). See part V.2 below.

3. Trading Facility and Electronic Trading Facility.

The terms of several exclusions and exemptions also vary depending on whether or not a contract, agreement or transaction is executed or traded on a "trading facility" or an "electronic trading facility". The Act defines "trading facility" as follows:

"(A) IN GENERAL. The term 'trading facility' means a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system.

(B) EXCLUSIONS. The term 'trading facility' does not include--

(i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm;

(ii) a government securities dealer or government securities broker, to the extent that the dealer or broker executes or trades agreements, contracts, or transactions in government securities, or assists persons in communicating about, negotiating, entering into, executing, or trading an agreement, contract, or transaction in government securities . . .; or

(iii) facilities on which bids and offers, and acceptances of bids and offers effected on the facility, are not binding.

Any person, group of persons, dealer, broker, or facility described in clause (i) or (ii) is excluded from the meaning of the term 'trading facility' for the purposes of this Act without any prior specific approval, certification, or other action by the Commission."

Speaking in the Senate on December 15, 2000, Senator Lugar, Chairman of the Senate Agriculture Committee, further clarified the definition of a 'trading facility' by explaining that such exclusion attempts:

". . . to address the advent of electronic trading and the changing and innovating nature of the financial industry. Indeed, we are keenly aware that there are newly emerging electronic systems that provide for the electronic negotiation of swaps agreements between and among large banks and other sophisticated major financial institutions acting as dealers. We do not intend for these systems to come within the definition of trading facilities." 146 Cong. Rec. S11925 (2000).

Congressman Leach, Chairman of the House Banking Committee, made a similar point in a Floor Statement released on December 15, 2000. He stated that:

"A final matter which deserves attention is the definition of 'trading facility' contained in section 103 of the legislation. Whether an entity is a 'trading facility' has ramifications as to whether or not the entity might be regulated by the CFTC and/or the SEC. It should be made clear that the definition of 'trading facility' is not to be construed so broadly as to include existing and developing electronic systems which permit parties to negotiate and enter into over-the-counter derivatives transactions." Floor Statement of Congressman James A. Leach on the Commodity Futures Modernization Act (Dec. 15, 2000).

An "electronic trading facility" is defined in the Act as a "trading facility" that:

"(A) operates by means of an electronic or telecommunications network; and

(B) maintains an automated audit trail of bids, offers, and the matching of orders or the execution of transactions on the facility."

4. Excluded Commodities and Exempt Commodities.

New Section 2(d) of the CEA contains a broad exclusion for qualifying transactions in "excluded commodities". New Section 2(h) of the CEA contains a somewhat more narrow exclusion for qualifying transactions in "exempt commodities". While Congress wanted to provide significant relief for transactions involving all non-agricultural commodities, the enactment of more narrow relief for exempt commodities was due to concerns with possible manipulation of the market price of such commodities.

The term "excluded commodity" is defined to mean:

"(i) an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure;

(ii) any other rate, differential, index, or measure of economic or commercial risk, return, or value that is--

(I) not based in substantial part on the value of a narrow group of commodities not described in clause (i); or

(II) based solely on 1 or more commodities that have no cash market;

(iii) any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction; or

(iv) an occurrence, extent of an occurrence, or contingency (other than a change in the price, rate, value, or level of a commodity not described in clause (i)) that is--

(I) beyond the control of the parties to the relevant contract, agreement, or transaction; and

(II) associated with a financial, commercial, or economic consequence."

The term "exempt commodity" means a "commodity that is not an "excluded commodity" or an "agricultural commodity".

Many types of transactions entered into under ISDA Master Agreements involve excluded commodities. Examples include interest rate, currency, credit, equity and weather derivatives and transactions involving commodities having no cash market. Transactions involving metals, chemicals or energy products, however, will be considered transactions involving exempt commodities.

IV. Contract Enforceability

Concerns about the enforcement of OTC derivatives transactions due to the exchange trading requirement of the CEA have been fully put to rest. Section 22 of the CEA is entitled "Private Right of Action". The Act adds a new clause (4) at the end of Section 22(a), which provides as follows:

"(4) CONTRACT ENFORCEMENT BETWEEN ELIGIBLE COUNTERPARTIES. No agreement, contract, or transaction between eligible contract participants or persons reasonably believed to be eligible contract participants, and no hybrid instrument sold to any investor, shall be void, voidable, or unenforceable, and no such party shall be entitled to rescind, or

recover any payment made with respect to, such an agreement, contract, transaction, or instrument under this section or any other provision of Federal or State law, based solely on the failure of the agreement, contract, transaction, or instrument to comply with the terms or conditions of an exemption or exclusion from any provision of this Act or regulations of the Commission." (emphasis added)

The Futures Trading Practices Act of 1992 added provisions to Section 12(e) of the CEA that preempted the application of state gaming and bucket shop laws to OTC derivatives transactions covered by an exemption granted by the CFTC pursuant to Section 4(c) of the CEA. The effect of this provision was to preempt the application of such state laws to transactions covered by the 1993 Swaps Exemption. The Act replaces Section 12(e)(2) of the CEA with a new provision that preempts the application of state gaming and bucket shop laws to transactions excluded from the CEA or exempt under regulations of the CFTC, whether or not the transactions would otherwise be subject to the CEA. This new provision makes preemption applicable to transactions covered by all the new exclusions in the Act as well as by the revised Treasury Amendment (see part IX below) and the new exclusion for electronic trading facilities (see part VII below).

V. Legal Certainty for Excluded Derivative Transactions
and for Excluded Swap Transactions

1. Section 2(d)(1).

New Section 2(d)(1) of the CEA states that nothing in the CEA (other than new Section 5b, which governs the regulation of derivatives clearing organizations, and revised Section 12(e)(2)(B), which is the preemption provision discussed in part IV above) governs or applies to a transaction in an "excluded commodity" if the transaction is (A) between persons that are eligible contract participants at the time they enter into the transaction and (B) not entered into or traded on a trading facility.

The Swaps Exemption (Part 35 of the CFTC Regulations) contains four elements:

(1) the swap agreement is entered into between eligible swap participants;

(2) the swap agreement is not part of a fungible class of agreements that are standardized as to their material economic terms;

(3) the creditworthiness of the parties is a material consideration in entering into or determining the terms of the swap agreement; and

(4) the swap agreement is not entered into or traded through a multilateral transaction execution facility.

The exclusion in new Section 2(d)(1) is much broader than the exemption embodied in the Swaps Exemption. First, a statutory exclusion that can only be modified by Congress is inherently more robust than a regulatory exemption that can be modified by agency action. Second, Section 2(d)(1) applies to any transaction and not just to swap agreements. Third, "eligible contract participant" is broader than "eligible swap participant" in several respects. Fourth, both the nonfungibility and creditworthiness requirements in the Swaps Exemption have been dropped. Finally, Section 2(d)(1) replaces "multilateral transaction execution facility" with "trading facility". The significance of this last change will only become apparent over time as the term "trading facility" is clarified through interpretation and experience. There is, of course, a separate exclusion for transactions executed through an electronic trading facility, as explained immediately below.

2. Section 2(d)(2).

New Section 2(d)(2) of the CEA provides an exclusion for transactions involving excluded commodities

that are executed or traded on an electronic trading facility. This exclusion covers all provisions of the CEA except Section 5a (to the extent provided in Section 5a(g), which permits a board of trade that elects to become a registered derivatives transaction execution facility to trade on the facility any transaction involving excluded or exempt commodities other than securities), Section 5b (governing the regulation of derivatives clearing organizations), 5d (governing exempt boards of trade) and Section 12(e)(2)(B) (the preemption provision discussed in part IV above). Section 2(d)(2) states that nothing in the CEA (except as noted immediately above) governs or applies to a transaction in an "excluded commodity" if the transaction is:

(A) entered into on a principal-to-principal basis by parties trading for their own account or by a party trading as an authorized investment manager or fiduciary as described in part III.2.C above;

(B) between persons that are eligible contract participants (other than when acting as a broker or in a similar agency function) at the time they enter into the transaction; and

(C) executed or traded on an electronic trading facility.

Speaking in the Senate on December 15, 2000, Senator Gramm, Chairman of the Senate Banking Committee, explained one aspect of the principal-to-principal requirement as follows:

"The Commodity Futures Modernization Act of 2000 excludes from its coverage agreements, contracts or transactions in an excluded commodity entered into on an electronic trading facility provided that such agreements, contracts or transactions are entered into only by eligible contract participants on a principal-to-principal basis trading for their own accounts. In some cases, a party may enter into an agreement, contract or transaction on an electronic trading facility that mirrors another agreement, contract or transaction entered into at about the same time with a customer. The risk of one transaction may be largely or completely offset by the other; and that may be the purpose for entering into both transactions. But the party entering into both transactions remains liable to each of its counterparties throughout the life of the transaction. That party is similarly exposed to the credit risk of each of its counterparties. The fact that a party has entered into back-to-back transactions as described above does not alter the principal-to-principal nature of each of the transactions and must not be construed to affect the eligibility of either transaction for the electronic trading facility exclusion." 146 Cong. Rec. S11867-8 (2000).

In a similar vein, in a Floor Statement released on December 15, 2000, Congressman Leach stated that:

"A 'principal-to-principal' transaction includes any transaction whereby a party to the transaction books the transaction for the party's own account. It includes 'riskless principal' transactions, whereby one

party enters into a transaction and thereafter or contemporaneously enters into an offsetting transaction so that the risk or payments under the transactions net out. The fact that the party has entered into offsetting transactions in no way alters the 'principal-to-principal' nature of the transaction, and any party that has entered into a 'riskless principal' transaction may be assured that its contracts remain legally enforceable and excluded or exempted from the jurisdiction of the CFTC and/or SEC, as applicable." Floor Statement of Congressman James A. Leach on the Commodity Futures Modernization Act (Dec. 15, 2000).

3. Section 2(g).

Although entitled "Excluded Swap Transactions", new Section 2(g) of the CEA applies to any transaction in a commodity other than an agricultural commodity. The Section 2(g) exclusion covers all provisions of the CEA subject to the same exceptions as set forth in Section 2(d)(2), which are explained in part V.2 immediately above. Section 2(g) states that nothing in the CEA (except as noted) governs or applies to a transaction in any commodity (other than an agricultural commodity) if the transaction is:

- (A) between persons that are eligible contract participants at the time they enter into the transaction;
- (B) subject to individual negotiation by the parties; and

(C) not executed or traded on a trading facility.

There is a great deal of overlap between the exclusions in Section 2(d)(1) (see part V.1 above) and Section 2(g). Section 2(d)(1), however, applies to "excluded commodities", while Section 2(g) applies to all commodities except agricultural commodities. The Section 2(g) exclusion thus will be particularly relevant to transactions not executed on a trading facility that involve metals, chemicals or energy products. In addition, the "subject to individual negotiation" requirement in Section 2(g) does not appear in Section 2(d)(1).

4. Title IV--Covered Swap Agreements.

As discussed in part X.2 below, Title IV of the Act (the Legal Certainty for Bank Products Act of 2000) creates an exclusion from the CEA for "covered swap agreements". The terms of this exclusion are substantially similar in aggregate effect to the exclusions discussed above. On a procedural level, the exclusions discussed above will in the first instance be interpreted by the CFTC.

The exclusion for "covered swap agreements" in Title IV of the Act should in the first instance be interpreted by the banking regulators.

VI. Legal Certainty for Transactions in Exempt Commodities

1. Section 2(h)(1).

New Section 2(h)(1) of the CEA states that nothing in the CEA (other than as noted immediately below) applies to a transaction in an "exempt commodity" if the transaction is (A) between persons that are eligible contract participants at the time they enter into the transaction and (B) not entered into on a trading facility. The provisions of (A) and (B) immediately above are almost identical to the comparable provisions of Section 2(d)(1). See part V.1 above. The only exceptions to the exclusion in Section 2(d)(1), however, are Sections 5b and 12(e)(2)(B) of the CEA. The exceptions to the exclusion in Section 2(h)(1) include not only Sections 5b and 12(e)(2)(B) but also a variety of provisions proscribing fraud in connection with commodity option transactions that are not between eligible commercial entities and manipulation of the market price of any commodity. "Eligible commercial entities" is defined as certain types of eligible contract participants that (i) have the ability to make or take delivery of the underlying commodity, (ii) incur commodity risks in addition to price risk or (iii) are dealers in either the underlying

commodity or derivatives transactions involving that commodity.

2. Section 2(h)(3).

New Section 2(h)(3) of the CEA provides an exclusion for transactions involving "exempt commodities" that are executed or traded on an electronic trading facility. Section 2(h)(3) states that nothing in the CEA (other than as noted immediately below) applies to a transaction in an "exempt commodity" if the transaction is (A) entered into on a principal-to-principal basis between persons that are eligible commercial entities at the time they enter into the transaction and (B) executed or traded on an electronic trading facility. There are various exceptions to this exclusion. The exceptions include Sections 5a (to the extent provided in Section 5a(g)), 5b, 5d and 12(e)(2)(B); these are the same exceptions as stipulated for the exclusion in Section 2(d)(2). See part V.2 above. In addition, the exceptions to Section 2(h)(3) include Sections 4b and 4o of the CEA and the related regulations proscribing fraud in connection with commodity option transactions and Sections 6(c) and 9(a)(2) of the CEA prohibiting manipulation of the market price of any commodity. Finally, the exceptions to the exclusion in

Section 2(h)(3) include any rules and regulations adopted by the CFTC to ensure timely dissemination by the electronic trading facility of trading data if the CFTC determines that the facility performs a significant price discovery function for the underlying commodity.

Section 2(h)(5) sets forth a variety of notification, certification, access to trading protocols and reporting obligations for any electronic trading facility relying on the exclusion set forth in Section 2(h)(3).

VII. Legal Certainty for Excluded Electronic Trading

Facilities

New Section 2(e)(1) of the CEA states that nothing in the CEA (except the preemption provision in Section 12(e)(2)(B)) governs or is applicable to an electronic trading facility that limits transactions authorized to be conducted on its facilities to those satisfying the requirements of Section 2(d)(2) (excluded commodities; see part V.2 above), Section 2(g) (excluded swap transactions; see part V.3 above) or Section 2(h)(3) (exempt commodities; see part VI.2 above). A designated contract market or a derivatives transaction execution facility is free to establish an excluded electronic trading facility.

VIII. Exclusion for Qualifying Hybrid Instruments

New Section 2(f)(1) of the CEA states that nothing in the CEA (except the preemption provision in Section 12(e)(2)(B)) governs or is applicable to a hybrid instrument that is predominantly a security. A hybrid instrument is predominantly a security if:

(A) the issuer receives payment in full of the purchase price substantially contemporaneously with delivery of the instrument;

(B) the holder of the instrument is not required to make any payments to the issuer, whether as margin, settlement payments, or otherwise, other than the purchase price, during the life of the instrument or at maturity;

(C) the issuer is not subject by the terms of the instrument to mark-to-market margining requirements;⁵
and

⁵ The Act makes clear that the mark-to-market limitation would not prevent an issuer of a secured debt obligation from increasing the amount of collateral pledged for the benefit of the holder to secure the issuer's repayment obligations.

(D) the instrument is not marketed as a futures contract or option on a futures contract.

This new hybrid instrument exclusion is substantially broader than the existing Hybrid Instrument Exemption (Part 34 of the CFTC Regulations) in several respects. First, hybrid instruments no longer have to satisfy the predominance test of whether the aggregate value of the commodity-independent components of the instrument exceeds the aggregate value of its commodity-dependent components. Second, hybrid instruments no longer are subject to a restriction on settlement by delivery of an instrument specified in the rules of a designated contract market. Finally, the exclusion is not subject to the limitations formerly imposed by Section 2(a)(1)(B) of the CEA (the Shad-Johnson Accord).

Hybrid instruments that are predominantly identified banking products are dealt with elsewhere in the Act. See part X.1 below.

IX. Legal Certainty for Treasury Amendment Products

The Act modifies the existing Treasury Amendment by providing a new Section 2(c) of the CEA. Under the new Section 2(c), the CEA, with limited exceptions, does not govern or apply to a transaction in foreign currency,

government securities, security warrants, security rights, resales of installment loan contracts, repurchase transactions in an excluded commodity, or mortgages or mortgage purchase commitments. Exceptions to this exclusion include Sections 5a (to the extent provided in Section 5(a)(g)), 5b, 5d and 12(e)(2)(B) of the CEA; these are the same exceptions as stipulated for the exclusion in Section 2(d)(2). See part V.2 above.

The Act also includes two other important limits on the Section 2(c) exclusion. The first grants the CFTC jurisdiction over futures contracts (or options thereon) or commodity options involving any of these enumerated products executed or traded on an "organized exchange". Organized exchange is defined as a "trading facility" that (A)(i) permits trading by or on behalf of a person that is not an eligible contract participant or (ii) permits trading other than on a principal-to-principal basis or (B) has adopted rules that (i) govern the conduct of participants (other than with respect to the submission of orders or execution of transactions on the facility), and (ii) contain disciplinary sanctions (other than exclusion from trading on the system). Organized exchange does not include a national securities exchange.

In addition, the CFTC is granted jurisdiction over foreign currency futures contracts (or options thereon) and options on foreign currencies offered to be entered into with a person that is not an eligible contract participant, unless entered into on a national securities exchange or unless the counterparty is one of an enumerated group of directly or indirectly regulated entities, such as a bank or other financial institution, broker-dealer, insurance company, financial holding company or investment bank holding company.

The changes in the Treasury Amendment eliminate the uncertainty in the former Treasury Amendment concerning the definition of "board of trade" by providing that transactions in the enumerated products are exempt unless effected on an organized exchange. Organized exchange is defined in such a way as to exclude CEA regulation of transactions executed through trading facilities on which participation is limited to eligible contract participants dealing on a principal-to-principal basis.

X. Regulatory Responsibility for Bank Products

The Act includes a new Title IV, which is entitled the "Legal Certainty for Bank Products Act of 2000". This title is part of neither the banking laws nor the CEA.

Title IV excludes the application of any provision of the CEA to, and CFTC regulatory authority over, certain identified banking products, hybrid instruments that are predominantly banking products and covered swap agreements.

1. Identified Banking Products and Hybrid Instruments.

Section 403 of Title IV provides an unqualified exclusion for an identified banking product if:

(A) an appropriate banking agency certifies that the identified banking product has been commonly offered, entered into or provided in the United States by any bank on or before December 5, 2000, under applicable banking law; and

(B) the product was not prohibited by the CEA and not regulated by CFTC as a contract of sale of a commodity for future delivery (or an option on such a contract) or an option on a commodity, on or before December 5, 2000.

Section 404 of Title IV provides an exclusion from all provisions of the CEA for new banking products offered after December 5, 2000 if:

(A) the product is not linked to and does not provide for delivery of an agricultural commodity; and

(B) the product or commodity is otherwise excluded from the CEA.

Section 405 of Title IV provides another exclusion from all provisions of the CEA for a product that is a hybrid instrument that is predominantly a banking product under a predominance test that is the same as the test hybrid instruments in new Section 2(f)(1) of the CEA. See part VIII above. Section 406 of Title IV sets forth procedures for decisions on predominance issues that involve both the CFTC and the Board of Governors of the Federal Reserve System.

Title IV defines "identified banking product" by reference to paragraphs (1) through (5) of Section 206(a) of the Gramm-Leach-Bliley Act, which define the term to include:

- (1) a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank;
- (2) a banker's acceptance;
- (3) a letter of credit issued or loan made by a bank;
- (4) a debit account at a bank arising from a credit card or similar arrangement;

(5) a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold--

(A) to qualified investors; or

(B) to certain other persons.

Title IV modifies the Gramm-Leach-Bliley definition of "bank" to cover any Federal depository institution, any non-U.S. bank or any U.S. branch or agency of a non-U.S. bank, any credit union, any trust company, certain corporations operating under the Federal Reserve Act and any of their respective subsidiaries that are regulated as part of the parent entity. Broker-dealers and futures commission merchants are specifically excluded. In addition, the Gramm-Leach-Bliley term "qualified investor" is replaced by "eligible contract participant" as defined in the Act.

2. Covered Swap Agreements.

Title IV also states a definition of "covered swap agreement". This definition in Title IV starts with Section 206(b) of Gramm-Leach-Bliley, which provides as follows:

"[T]he term 'swap agreement' means any individually negotiated contract, agreement, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one

or more commodities, securities, currencies, interest or other rates, indices, or other assets, but does not include any other identified banking product, as defined in paragraphs (1) through (5) of subsection (a)."

Section 402(d) of the Act then provides that "covered swap agreement" means a swap agreement (as defined in section 206(b) of the Gramm-Leach-Bliley Act), including a credit or equity swap, based on a commodity other than an agricultural commodity enumerated in Section 1a(4) of the CEA if:

(1) the swap agreement:

(A) is entered into only between persons that are eligible contract participants; and

(B) is not entered into or executed on a trading facility; or

(2) the swap agreement:

(A) is entered into or executed on an electronic trading facility;

(B) is entered into on a principal-to-principal basis between parties trading for their own accounts or by a party trading as an authorized investment manager or fiduciary as described in part III.2.C above;

(C) is entered into by persons that are eligible contract participants (other than when acting as a broker or in a similar agency function) at the time they enter into the transaction; and

(D) is a transaction in an excluded commodity.

Section 407 then sets forth a broad exclusion for "covered swap agreements". It provides that no provision of the CEA (other than Section 5b with respect to the clearing of covered swap agreements) shall apply to, and the CFTC shall not exercise regulatory authority with respect to, a covered swap agreement offered, entered into or provided by a bank.

XI. Regulatory Responsibility for Security-Based Swap Agreements

Title III of the Act amends both the 1933 Act and the 1934 Act to clarify the status of "swap agreements" under the U.S. securities laws. The Act adds a new definition of "swap agreement" in the form of Section 206A of the Gramm-Leach-Bliley Act. This new definition includes a broad array of interest rate, currency, credit, equity, commodity, weather and other derivatives, provided that

transactions are entered into by eligible contract participants and the material terms of the transaction (other than price and quantity) are subject to individual negotiation. "Swap agreement" for this purpose does not include transactions involving the purchase or sale of a security or a put, call, straddle or option on a security, using for this purpose the definition of "security" found in Section 2(a)(1) of the 1933 Act and Section 3(a)(10) of the 1934 Act. Title III adds a new Section 2A to the 1933 Act and a new Section 3A to the 1934 Act stating that for purposes of the U.S. securities laws "security" does not include any "swap agreement". These new provisions effectively end any confusion about the status of swaps under the U.S. securities laws that arose from the enforcement order of the SEC involving Bankers Trust Company dated December 22, 1994.

Title III of the Act distinguishes between "security-based swap agreements" and "non-security based swap agreements". The former means a "swap agreement" (as defined above in this part XI) of which a material term is based on the price, yield, value or volatility of any security or any group or index of securities. The latter

means any swap agreement that is not a security-based swap agreement.

Security-based swap agreements are subject to specific antifraud, antimanipulation and anti-insider trading provisions of the 1933 Act and 1934 Act (including judicial precedents under those provisions) to the same extent such provisions are applicable to securities. The SEC may not, however, promulgate or enforce rules or orders that impose reporting or recordkeeping requirements or other procedures or standards as prophylactic measures against fraud, manipulation or insider trading with respect to security-based swap agreements, or otherwise regulate or require the registration of security-based swap agreements under either the 1933 Act or the 1934 Act.

Speaking in the Senate on December 15, 2000, Senator Gramm provided the following explanation of the SEC's authority concerning security-based swap agreements:

"Under Title III of the bill, the SEC is granted new authority to undertake certain enforcement actions in connection with security-based swap agreements. It is important to emphasize that nothing in the title should be read to imply that swap agreements are either securities or futures contracts. To emphasize that point, the definition of a 'swap agreement' is placed in a neutral statute, the Gramm-Leach-Bliley Act, that is, legislation that is not specifically part of a banking, securities, or commodities law. However, drawing upon the SEC's enforcement experience, the SEC

is permitted, on a case-by-case basis, with respect to security-based swap agreements (as defined in the legislation) to take action against fraud, manipulation, and insider trading abuses. Title III makes it clear that the SEC is not to impose regulations on such instruments as prophylactic measures. Banks are already heavily regulated institutions. Further regulatory burden, rather than discouraging wrongdoing, would be more likely to discourage development and innovation, driving business overseas instead. The SEC is directed to focus on the wrong doers rather than provide new paperwork burden and regulatory costs on the law abiding investors and financial services providers. For example, the SEC is directed not to require the registration of security-based swap agreements. If a registration statement is submitted to the SEC and accepted by the SEC, the agency is required promptly to notify the registrant of the error, and the registration statement will be null and void." 146 Cong. Rec. S11867 (2000).

XII. Other Important Provisions of the Act

1. Clearing.

While transactions qualifying for the exclusions described above may be cleared, Congress wanted to be sure that clearing organizations themselves are subject to suitable regulation. The Act establishes two new categories of regulated clearing organizations for derivatives: "multilateral clearing organizations", which are subject to banking regulation; and "derivatives clearing organizations", which are subject to CFTC regulation. OTC derivatives transactions eligible for the exclusions described above in this Memorandum, if cleared, must be

cleared through a multilateral clearing organization, a derivatives clearing organization registered under the CEA, a securities clearing agency regulated by the SEC under the 1934 Act or certain foreign clearing organizations approved by the SEC, the CFTC or the Federal banking regulators. Clearing will not, however, make those exclusions unavailable.

CFTC-registered derivatives clearing organizations must comply with a set of core principles and will be regulated independently of any trading facility for which they clear transactions.

2. Regulatory Relief for Contract Markets.

The Act creates three tiers of regulation for boards of trade based on whether the underlying commodities being traded are susceptible to manipulation and whether the users of the facility are limited to eligible contract participants.

The highest level of regulation is for designated contract markets. The Act amends the current approach to regulation of these markets with a series of "core principles" that are intended to be more flexible. Existing contract markets are not required to requalify under the new

provisions, although they will be subject to ongoing compliance with the core principles.

The Act creates a new category of regulated trading facility, known as a Derivatives Transaction Execution Facility or "DTEF", which is subject to less regulation (through a less comprehensive body of core principles) than a designated contract market. Operation as a DTEF will require registration under new Section 5a(c) of the CEA. The Act permits a narrower range of contracts to be traded on DTEFs than on contract markets, depending in part on the types of participants granted access. Transactions involving any commodity (other than an agricultural commodity) are permitted if the DTEF limits access to "eligible commercial entities"⁶ trading for their own accounts. If trading access is not so limited, the DTEF may permit transactions involving any underlying commodity that has (i) a nearly inexhaustible deliverable supply, (ii) a deliverable supply that is sufficiently large that the contract is "highly unlikely to be susceptible to the

⁶ "Eligible commercial entities" is defined as certain types of eligible contract participants that (i) have the ability to make or take delivery of the underlying commodity, (ii) incur commodity risks in addition to price risk or (iii) are dealers in either the underlying commodity

threat of manipulation" or (iii) no cash market. Trading access must be limited to eligible contract participants or persons trading through a futures commission merchant that has net capital of at least \$20,000,000 and meets certain other requirements. The Act also permits trading on a DTEF of transactions that would otherwise be excluded or exempt from the CEA under the provisions described in other parts of this Memorandum.

The Act further authorizes a third category of trading facility, an "exempt board of trade". Becoming an exempt board of trade does not require registration with the CFTC; it merely requires receipt by the CFTC from the exempt board of trade of a notice in a manner to be prescribed by the CFTC. To qualify, an exempt board of trade may permit only contracts for sale of a commodity for future delivery (or options on such contracts or on a commodity) between eligible contract participants for which the underlying commodity has (i) a nearly inexhaustible deliverable supply, (ii) a deliverable supply that is sufficiently large, and a cash market sufficiently liquid, "to render any contract traded on the commodity highly unlikely to be

or derivatives transactions involving that commodity.

susceptible to the threat of manipulation", or (iii) no cash market. Contracts involving securities or any group or index of securities may not be traded on an exempt board of trade. A party to a transaction that is traded on an exempt board of trade is subject to various antimanipulation and antifraud provisions of the CEA. In addition, if the CFTC finds that an exempt board of trade is a significant source of price discovery for the cash market for the commodity underlying any transaction traded through the exempt board of trade, the board of trade will be required to disseminate publicly on a daily basis trading volume, price and other trading data as appropriate to the market. Although transactions involving "excluded commodities" may be traded through an exempt board of trade, doing so would appear to submit such transactions to antifraud and antimanipulation provisions of the CEA that would not apply under Section 2(d)(2) of the CEA if the same transactions were entered into through an electronic trading facility. See part V.2 above.

A designated contract market or a DTEF is permitted to operate an exempt board of trade so long as it is organized as a separate legal entity.

3. Futures on Single and Narrow Indices of Securities.

Until the Act became law, Section 2(a)(1)(B) of the CEA (the Shad-Johnson Accord) prohibited futures on single shares and narrow indices of securities. The Act will now permit the trading in the United States of futures on individual securities and narrow-based groups or indices of securities. Thus provisions generally will not take effect for one year. Regulation is to be coordinated by both the CFTC and the SEC. Related tax provisions were adopted as part of the Community Renewal Tax Relief Act of 2000; these provisions generally conform the taxation of futures on single shares or narrow indices of securities to the taxation of options on single shares.

Section 201 of the Act amends Section 3(a) of the 1934 Act to add a definition of "security future", which is "a contract for sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof" subject to certain exceptions. In particular, "security future" does not include any transaction excluded from the CEA under CEA Sections 2(c) (Treasury Amendment; see part IX above), 2(d) (excluded derivatives transactions; see part V above), 2(f)

(hybrid instruments; see part VIII above) or 2(g) (swap transactions); see part V.3 above) or under Title IV of the Act (identified banking products and covered swap agreements; see part X above). These exclusions from the definition of "security future" were intended to clarify that OTC derivatives transactions among eligible contract participants related to the prices of securities are outside the jurisdiction of the SEC.

XIII. Future Developments--Retail Study

Section 105(c) of the Act directs the Board of Governors of the Federal Reserve System, the Secretary of the Treasury, the CFTC and the SEC to conduct a study of issues involving offering swap agreements to persons other than eligible contract participants. The study will address:

- (A) the potential uses of swap agreements by persons other than eligible contract participants;
- (B) the extent to which financial institutions are willing to offer swap agreements to persons other than eligible contract participants;
- (C) the appropriate regulatory structure to address customer protection issues that may arise in

connection with the offer of swap agreements to persons
other than eligible contract participants; and

(D) other relevant matters deemed necessary or
appropriate.

A report is due to be submitted to Congress within
one year after enactment of the Act. The report will
include recommendations for necessary and appropriate
legislative action.

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