HEARING TO REVIEW REAUTHORIZATION OF THE COMMODITY EXCHANGE ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES AND RISK MANAGEMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

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HEARING TO REVIEW REAUTHORIZATION OF THE COMMODITY EXCHANGE ACT

WEDNESDAY, SEPTEMBER 26, 2007

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

The Subcommittee met, pursuant to call, at 10 a.m., in Room 1300 of the Longworth House Office Building, Hon. Bob Etheridge [Chairman of the Subcommittee] presiding.

Members present: Representatives Etheridge, Marshall, Boyda, Peterson [*ex officio*], Moran, Conaway and Goodlatte [*ex officio*].

Staff present: Andy Baker, Adam Durand, Alejandra Gonzalez-Arias, Scott Kuschmider, Clark Ogilvie, John Riley, Sharon Rusnak, Kristin Sosanie, Bryan Dierlam, Kevin Kramp, and Jamie Weyer.

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

Mr. ETHERIDGE. This hearing of the Subcommittee on General Farm Commodities and Risk Management to review the reauthorization of the Commodity Exchange Act will come to order. To begin with, I ask unanimous consent that Mr. Barrow may sit with the Committee, without objection.

Most Americans by now know that Congress needs to pass a new farm bill this year. Fewer Americans probably know that we also need to reauthorize the Commodity Futures Trading Commission. The futures industry impacts our lives every single day. Derivatives trading provides customers with fora for price discovery and price hedging for a wide variety of commodities and financial instruments. As the oversight agency for derivatives, the CFTC keeps watch over a trillion dollar industry that affects almost everything, from the price of corn, wheat and soybeans that goes into our food products, to the interest you pay on mortgages. It is the CFTC's mission to foster the economic utility of the futures markets by encouraging their competitiveness and effectiveness, ensuring their integrity and protecting market participation against manipulation, abusive trading practices and fraud.

In 2000, Congress took a bold step in dramatically changing how the CFTC oversees derivatives markets by moving from a regulatory regime to a principles-based structure. We removed the shackles that restrained an industry and we have seen the good results of Congress's work. Now, here we are, almost 7 years removed from that point and people are asking questions, whether the regulatory regime we created in 2000 is appropriate for every commodity, whether we should increase the Commodity Futures Trading Commission's authority in some areas. Therefore, as this Subcommittee moves forward with reauthorization, it is an appropriate time for us to review what Congress accomplished with the Commodity Futures Modernization Act of 2000 and the CFTC's oversight of these markets.

Today we will hear from a variety of participants in the futures industry. I hope my colleagues will find this hearing informative. I know I am looking forward to hearing today's testimony from our witnesses. One of the messages we will hear from most of the witnesses today concerns enforcement actions taken by the CFTC and the Federal Energy Regulatory Commission. There is a growing fear that recent FERC action may be encroaching upon the CFTC's exclusive jurisdiction over the futures markets. The CFTC and FERC have a good working relationship and they have been working cooperatively since enactment of the Energy Policy Act of 2005. However, when Congress passed the Energy Policy Act, nowhere did it repeal or limit the Commodity Exchange Act's explicit grant to the CFTC of exclusive jurisdiction over the futures market.

I do not know why the FERC chose to take an enforcement action, which has called its own authority into question. I do not know that it was Congress's intent that the CFTC should have exclusive jurisdiction over futures markets. For the CFTC to fail to assert its exclusive jurisdiction, when appropriate, would equal a failure to uphold the will of Congress. But we will have more opportunity to discuss this with our witnesses. I want to welcome each of you here today and thank you for testifying.

With that, I now turn to the gentleman from Kansas, my good friend, Mr. Moran, for his opening statement.

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

Mr. MORAN. Mr. Chairman, thank you very much. We gather here today to determine information about the commodities futures markets of the United States in preparation for reauthorization of the Commodity Exchange Act. As I said earlier, the family has gathered once again. Perhaps this time we can have an end result with a bill that becomes law. We do have a diverse group of witnesses with us today from different sectors within the industry and I pledge that I will pay close attention to what these individuals have to say.

Since the passage of the Commodity Futures Modernization Act of 2000, this industry has experienced record growth. Growth in the commodities future industry has provided new ways for businesses to manage risk and has substantially benefited the U.S. economy. With growth, however, comes new challenges. Recently, the natural gas derivatives market has become the center of public attention and in July, this Subcommittee held a hearing on natural gas markets. As I stated then, it is the duty of the Subcommittee to examine how markets, like exempt commercial markets, have evolved and decide whether regulatory changes should be made. In doing so, the Subcommittee should be adequately informed and only proceed in a deliberative manner.

As I have said in the past, we should be cautious in making sweeping changes to a system that has brought new investment and growth to the U.S. economy. Any changes to the Commodity Futures Modernization Act by this Subcommittee must take into account any possible adverse effects new regulatory burdens on the market would have. We should be wary of actions that might stifle market growth, drive markets overseas or discourage entrepreneurs from developing new and legitimate markets.

I thank the witnesses for their testimony today and I thank Chairman Etheridge for holding this hearing. I look forward to working with you, Mr. Etheridge, to see that we reauthorize the Commodity Exchange Act in a conscious, yet expeditious manner. Thank you, Mr. Chairman.

[The prepared statement of Mr. Moran follows:]

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

Thank you, Mr. Chairman. We are here today to gather information on the commodity futures markets in the United States in preparation for the reauthorization of the Commodity Exchange Act. To that end we have before us a diverse group of witnesses from many different sectors of the industry. Each witness is an important player in the commodity futures industry and it is incumbent upon this Subcommittee to listen closely to what these individuals have to say. In the end, it is they who will have to contend with any new regulations that we create during reauthorization.

Since passage of the Commodity Futures Modernization Act in 2000, this industry has experienced record growth. Growth in the commodity futures industry has provided new ways for businesses to manage risk and has substantially benefited the U.S. economy. With growth, however, come new challenges. Recently, the natural gas derivatives market has become the center of public attention and on July 12, 2007, this Subcommittee held a hearing on the natural gas markets.

As I stated then, it is the duty of this Subcommittee to examine how markets, like exempt commercial markets (ECMs), have evolved and decide whether a regulatory change should be made. In doing so the Subcommittee should be adequately informed and only proceed in a deliberate manner. As I have said in the past, we should be cautious in making sweeping changes to a system that has brought new investment and growth to the U.S. economy. Any changes to the Commodity Futures Exchange Act by this Subcommittee must take into account any possible adverse effects new regulatory burden will have on the market. We should be wary of actions that might stifle market growth, drive markets overseas, or discourage entrepreneurs from developing new and legitimate markets.

I want to thank all the witnesses for your testimony today. I also want to thank Chairman Etheridge for holding this hearing. I hope we can work to together to reauthorize the Commodity Exchange Act in a conscious, yet expeditious manner.

Mr. ETHERIDGE. I thank the gentleman and appreciate his comments. The chair would request that other Members submit their opening statements for the record so that the witnesses may begin their testimony and we ensure that there is ample time for questions.

[The prepared statements of Messrs. Peterson, Goodlatte, Graves, and Salazar follow:]

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

Thank you, Chairman Etheridge, for calling this hearing today, and for all the important work you have done on this issue in preparation of reauthorizing the Commodity Exchange Act.

We have spent the better part of the year preparing and passing a farm bill here in the House, but today we renew examination of another area of interest in this Committee that affects every producer and consumer in America: the derivatives markets. Everyone who pays a grocery bill or gas bill, or who applies for a loan or has a mortgage, is affected by these markets.

Congress last reauthorized the Commodity Exchange Act in 2000, making what at that time were the most significant changes in the law since the Commodity Futures Trading Commission was created in 1974. When the CFTC was established, the majority of futures trading took place in the agricultural sector. Even today, most people probably associate futures trading with people in pits in Chicago or New York, loudly haggling over contracts for orange juice or porkbellies. The reality is that derivatives have become increasingly varied over time and today encompass a wide selection of highly complex financial products and indicators like bonds, currencies, interest rates and stock indexes.

Congress allowed for various levels of regulation of futures contracts in the 2000 reauthorization, in part to handle the demand for these products. Both the CFTC-regulated exchanges and the over-the-counter exchanges have experienced strong annual growth in trading volumes since then, along with the proliferation of new trading products and participation of more investors of all classes than ever before.

Every farmer, producer, processor and consumer benefits from open, transparent derivatives markets. Consequently, every one of us pays the price if these markets are manipulated or distorted. Because futures prices are used as points of reference for many physical transactions, manipulation in the futures markets can have a significant effect on what consumers pay and what farmers and producers receive. That makes the activities of the derivatives markets very much in the public interest.

It is my hope that today's hearing will give us a good understanding of what needs to be done in this reauthorization given the changes in derivatives markets since the last reauthorization was passed.

I welcome today's witnesses and I yield back my time.

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

Thank you Mr. Chairman, and thank you for holding this hearing. I believe it is essential to reauthorize the Commodity Futures Trading Commission, which was last reauthorized by the Commodity Futures Modernization Act (CFMA) and expired in 2005.

The CFMA has been lauded by many as the most significant amendments to the Commodity Exchange Act since the CFTC was created in 1974. The CFMA provided for the creation of unregulated futures exchanges, where all trading involved sophisticated or professional investors. Both the exchanges and the OTC markets have experienced strong growth in trading volumes since 2000. More recently both have experienced increased volatility. I am anxious to hear what our witnesses think causes this volatility and if it, in anyway, degrades the price discovery function of the futures markets.

I've watched the CFTC's response to the market volatility and I have been impressed with its efforts and achievements. That does not mean that all should be left as is. I think the CFTC takes very seriously its primary responsibility as the exclusive regulator of the futures markets. I know the Commission would like and believe it needs more resources. I am interested to learn that the Commission now also believes it needs more enforcement tools. What government agency or regulator doesn't?

I am more interested to learn what the regulated community believes. Has the CFTC done an effective job of regulating the futures markets? Does it need more enforcement tools or oversight capability? Does it need more regulatory authority? Is it under-funded?

These are all questions that need to be answered before we can craft the next reauthorization effort. The witnesses that are assembled today will be able to provide this Committee with that insight. I doubt we need to craft changes as significant as those in 2000, but I know we need to adequately address the concerns of our witnesses today.

Thank you Mr. Chairman.

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

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

As most of my colleagues on this panel know, the reauthorization of the Commodity Exchange Act is very important to me and my constituents. It is my full intention to work with all parties involved to reach a deal that is amicable to everyone and I am hopeful that we can reauthorizes this program with everyone's support.

We can all agree that the quicker we reauthorize the Commodity Exchange Act the sooner everyone can get back to business, and I think that is in the best interest of everyone here today.

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

PREPARED STATEMENT OF HON. JOHN T. SALAZAR, A REPRESENTATIVE IN CONGRESS FROM COLORADO

Good morning. I first want to thank Chairman Etheridge and Ranking Member Moran for holding this important hearing today.

As relieved as I am for completing our portion of the 2007 Farm Bill, I know there is still work to be done.

With that said, I want to thank all of the witnesses for coming in today to discuss such a vital issue for farmers today.

I can only imagine how busy all of you have been with the record harvests taking place.

Over the last few weeks Colorado has had a record wheat harvest and corn is soon to come.

As you know, this Act has been around for over 70 years with just a few changes taking place since the original Act in 1936.

I want to reiterate something I stated many times during the farm bill hearings.

Our average age of U.S. farmers is 55 years old, and I blame it on one reason—there is not enough profitability in agriculture.

I think the 2007 Farm Bill has been written to benefit the producer and not the consumer like many farm bills in the past.

As we move forward reviewing the Commodity Exchange Act, I want to make sure we do what we can do take care of our farmers.

Thanks again to the leadership of the Committee for their hard work and I look forward to hearing the testimony.

Mr. ETHERIDGE. I would like to begin to welcome each of you panelists to the table this morning. Thank you for coming and being with us.

Our first witness is Mr. Duffy, who is the Executive Chairman of the Chicago Mercantile Exchange Group in Chicago; second witness is Dr. Newsome, President and CEO of the New York Mercantile Exchange in New York; Mr. Carlson, who is the Corporate Secretary and Treasurer of Minneapolis Grain Exchange in Minneapolis, Minnesota; Mr. Sprecher, who is Chairman and CEO of the IntercontinentalExchange in Atlanta, Georgia; and Dr. Walsh, who is Executive Vice President, Chicago Climate Exchange in Chicago, Illinois.

Mr. Duffy, please begin when you are ready. I would ask if you would, please, to the extent possible, to summarize your statements in 5 minutes and your total statement will be included in the record. Thank you. If you will please begin.

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

Mr. DUFFY. Thank you, Mr. Chairman. I am Terry Duffy. I am the Executive Chairman of the Chicago Mercantile Exchange Group. I want to thank you, Chairman Etheridge, 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 continues the reauthorization process. CME Group was formed by the merger of Chicago Mercantile Exchange Holdings and Chicago Board of Trade Holdings. CME Group is the parent of CMS and the Board of Trade. CME Group also owns Swapstream Operating Services Limited, an OTC trading facility, and owns an interest in FXMarketspace Limited, an FX trading platform. We serve the global risk management needs of our customers and those who rely on price discovery formed by our competitive markets.

We offer a comprehensive selection of benchmark products, including most major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, energy and alternative investment products, such as weather and real estate. I submitted my full testimony for the record and will summarize our major points here first.

The CFTC's implementation of the CFMA: The CFTC's administration of the Commodity Futures Modernization Act of 2000 has been a tremendously positive force for the derivatives industry. We think that the success of the U.S. derivatives industry under the regulatory regime created by the CFMA provides a compelling example for the securities industry. The reduction of barriers to new and cross-border entry into the global futures and options industry has spurred growth and innovation. U.S. investors can directly trade foreign futures and options contracts from the United States. Also, European and Asian investors can directly trade products listed by CME Group and other U.S. futures and options exchanges from abroad.

U.S. capital markets have not had the same advantage. The overly prescriptive regulation imposed on U.S. securities exchanges and issuers is blamed, in part, for the success of foreign securities exchanges and the gravitation of major IPOs to offshore markets. The problems with the securities regulation have been cited to revive a call for merging the CFTC and the SEC. The inadequacies of security markets regulation need to be resolved by reform of that regulatory regime. It cannot be resolved by subjecting derivative markets to a system that is not credible in a global economy. Minor jurisdictional disputes have no bearing on effective regulation of derivatives or securities. Moreover, the CFTC has done its best to find a solution that permits questioned products to trade under both regimes and permits the marketplace to choose.

Second, CME's recommendation for reauthorization: We enthusiastically applaud the success of the CFMA and urge the CFTC be reauthorized. The U.S. futures industry kept its place as a world leader and innovator because CFMA adopted a principles-based regulatory regime and the CFTC fostered the concept. Reauthorization offers a valuable opportunity to fine tune CFMA based on experienced gained since 2000. CME offers two recommendations.

Off-exchange retail FX futures trading: The fact that the CFTC and NFA are compelled to devote a large share of their resources to protecting retail customers from widespread fraud in OTC FX markets is evidence that a serious problem exists. We have lost track of the number of CFTC and NFA enforcement actions since we first urged elimination of the exemption that permitted off-exchange trading of retail foreign exchange contracts. As expected, there have been hundreds of enforcement actions, hundreds of millions of dollars in fraudulent losses to small traders and each day brings new examples.

At a minimum, we need an amendment that will clarify the retail FX system that do not regularly settle contracts by delivery are subject to CFTC registration requirements; that is, unless they are operated by banks or other financial institutions. Further, it should be specified that such systems may only be operated by Designated Contract Markets or well-capitalized and fully regulated futures commodity merchants. In addition, all intermediaries who serve the same function as commodity pool operators, commodity trading advisors and introducing brokers, should register as such and be subject to comparable regulation.

Exempt commodity markets: Section 5(b) of the Commodity Exchange Act charges the Commission with the duty to oversee the system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals. It is the Commission's responsibility to deter and prevent price manipulation or any other disruptions to market integrity, to ensure the financial integrity of all transactions subject to this chapter and the avoidance of systemic risk and to protect all market participants from fraudulent or other abusive sales practices. These purposes, in the statutory exemption for commercial markets found in Section 2(h)(3) are in conflict.

The key purpose mandated by Congress in Section 5(b) is jeopardized if trading facilities for contracts in exempt commodities are permitted to coexist with regulated futures exchanges that list those same commodities. Exempt commercial markets do not have any system to effectively self-regulate their facilities or their market participants. Their contracts are traded based on the price of commodities that have limited supplies and that have often been the subject of manipulative activity and disruptive market behavior.

There is no mechanism in place to deter or prevent price manipulation or any other disruptions to market integrity. The Commission cannot track the buildup of dominant positions. At best, the Commission has the power to punish such conduct only after the fact. We find this to be a serious problem that is at odds with Congress's intent behind CFMA. If left unaddressed, the situation jeopardizes the public's confidence and the CFTC's ability to do its job.

The Section 2(h)(3) exemption for unregulated commercial markets should be eliminated. You can't fix the problem by merely changing reporting requirements. In order to secure accurate reports, a market needs an effective surveillance and compliance system. This requires that an effective system of self-regulation must be put in place. The logical conclusion is that you must implement at least the core principles required of derivative transaction execution facilities to get a useful result.

Before I conclude, I want to make mention of the periodic attempts to impose transaction tax on exchange traded futures contracts. That effort is utterly misguided. First, the tax will fall on liquidity providers who will simply be driven offshore to untaxed exchanges. Second, the regulated exchanges already pay for the Commission's direct oversight and their customers pay a fee to the National Futures Association for the services it performs, many of which have been off-loaded from the CFTC.

Finally, the CFTC's expenses and need for additional staff are attributed to off-exchange frauds and manipulations, not self-regulated trading. To close, CME Group, its members and their customers and the Nation's market-based economy have prospered under CFMA. The CFTC deserves commendation and should be reauthorized. The principles of CFMA should be reaffirmed. Mr. Chairman, I thank you very much for your time this morning.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CHICAGO MERCANTILE EXCHANGE GROUP, INC., CHICAGO, IL

I am Terrence Duffy, Executive Chairman of Chicago Mercantile Exchange Group, Inc., ("CME Group" or "CME"). Thank you Chairman Etheridge 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 continues the reauthorization process. CME Group was formed by the merger this year of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. CME Group is the parent of CME Inc. and The Board of Trade of the City of Chicago Inc. (the "CME Group Exchanges"). CME Group also owns Swapstream Operating Services Limited, an OTC trading facility, and owns an interest in FXMarketspace Limited, an FX trading platform that is authorized and regulated by the Financial Services Authority. The CME Group Exchanges serve the global risk management needs of our customers and those who rely on the price discovery provided by the competitive markets maintained by the Exchanges. The CME Group Exchanges offer a comprehensive selection of benchmark products in most major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, energy, and alternative investment products such as weather and real estate. Additionally, we offer order routing, execution and clearing services to other exchanges by means of our Globex® electronic trading platform and our clearing house. CME Group is traded on the New York Stock Exchange and NASDAQ under the symbol "CME."

I. The CFTC'S Implementation of CFMA

I am pleased to give our view of the achievements of the Commodity Futures Trading Commission and the successes of our industry made possible by the Commodity Futures Modernization Act of 2000 ("CFMA"). The CME Group commends Congress, and the agriculture committees, for the foresight in 2000 to enact a principles-based regulatory regime for our industry.

The success of the derivatives industry sharply contrasts with developments in U.S. capital markets. Foreign exchanges have been attracting new listings to the apparent detriment of U.S. markets—thereby focusing negative attention on the U.S. regulatory system for securities exchanges and issuers. There is concern that U.S. security markets have been hamstrung in meeting international competition by overly-prescriptive regulation. A strong case has been made that innovation is slowed and U.S. markets cannot attain a first mover advantage because of the lag between idea and implementation imposed by the regulatory regime.

We think that the marked success of the U.S. derivatives industry under the regulatory regime created by the CFMA provides a compelling example for the securities industry. In our view, reducing or limiting barriers to entry in the global futures and options industry has strongly contributed to business growth. For example, the compounded annual growth rate of the global futures and options industry from 2000 through 2006 was 28% compared to only 4% for equity securities markets. This is due, at least in part, to the fact that U.S. investors can directly and electronically trade foreign futures and options contracts from the U.S. Correspondingly, European and Asian investors can directly and electronically trade products listed by CME and other U.S. futures and options exchanges. Moreover, foreign boards of trade can efficiently offer U.S. customers access to products also traded on U.S. exchanges, thereby increasing global competition in these markets. In contrast, under current SEC rules, U.S. investors cannot directly and electronically trade foreign equity securities of foreign issuers that do not comply with SEC disclosure standards or U.S. GAAP accounting standards. The CFTC has wisely promoted global growth and competition while recognizing that comparability in regulatory standards is superior to insisting upon additional, but not necessarily better, regulatory requirements.

Despite this record, we are concerned that most discussions of regulatory shortcomings in the U.S. lump derivative and security markets together and treat the regulatory problem as if it were caused by separate regulation of those two sectors. We have not discovered a single, considered explanation of why separate regulation of futures and securities has adversely impacted securities markets.

The U.S. futures industry kept its place as a world leader and innovator because CFMA adopted a principles-based regulatory regime and the Commission embraced and fostered the concept. CFMA set the stage for innovation and international expansion of U.S. futures markets.

Some observers argue that the occasional jurisdictional "overlap" between the CFTC and SEC with respect to some innovative new products demonstrates a dysfunctional system that must be changed. Those "border disputes" certainly exist and are unfortunate, but they have no bearing on the effective and efficient regulation of the great mass of futures products that lie solely within CFTC's jurisdictional purview. The proper resolution is the course that the CFTC pioneered, *i.e.,* finding a solution that permits the new products to trade under both regimes and permitting the "market" to choose.

The continuing call for merging the CFTC and the SEC is sometimes justified as a means to resolve these minor conflicts. Such a merger has no value for futures markets which already enjoy principal-based regulation. There is no benefit to the customers, since the most likely outcome will be the elimination of the better regulatory system. The inadequacies of securities market regulation cited by critics need to be resolved by reform of that regulatory regime, not by subjecting derivative markets to a system that is not credible in a global economy.

Perhaps it is premature to comment, but there appears to be a serious jurisdictional conflict between the CFTC and the Federal Energy Regulatory Commission ("FERC"), arising out of FERC's prosecution of Amaranth in connection with its trading of natural gas on NYMEX, a designated contract market subject to the exclusive jurisdiction of the CFTC. Section 2(a)(1)(A) of the CEA provides: "The Commission shall have exclusive jurisdiction, except to the extent otherwise provided in subparagraphs (C) and (D) of this paragraph and subsections (c) through (i) of this section, with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated or derivatives transaction execution facility registered pursuant to section 7 or 7a of this title or any other board of trade, exchange, or market . . . ." The CFTC investigated Amaranth's conduct and charged it with an attempted manipulation under the CEA. FERC investigated the same conduct and charged Amaranth with manipulative conduct under the different standard applicable in its statute. FERC is taking the position that it has jurisdiction over conduct on a futures exchange if that conduct impacts cash markets under its jurisdiction. In effect, FERC reads the CFTC's exclusive jurisdiction out of existence. The prosecution of the same conduct by separate Federal agencies under differing standards creates exactly the sort of conflict that Congress sought to avoid by limiting the reach of FERC jurisdiction.

II. CME's Recommendations for Reauthorization

We urge that the CFTC be reauthorized. Generally we agree that CFMA has been a resounding success, but we also believe that reauthorization offers a valuable opportunity to fine tune that statute based on industry experience gained in the 7 years since the CFMA's enactment. In that regard, CME offers three recommendations for consideration. We also wish to comment on the recurring efforts to impose a transaction tax on exchange traded futures to fund the Commission.

Off-Exchange Retail FX Futures Trading

The first area in need of fine tuning involves retail, off-exchange trading of foreign exchange derivatives. We have lost track of the number of CFTC and NFA enforcement actions since we first urged elimination of the exemption that permitted off-exchange trading of retail foreign exchange contracts. As we predicted, there have been hundreds of enforcement actions, hundreds of millions in fraudulent losses to small traders, and each day brings new cases and more losses. The confluence of the massive continuing frauds committed against retail customers by fly-by-night foreign exchange dealers, and the 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 off-exchange retail foreign exchange futures and the threshold definition of what transactions should be subject to CFTC jurisdiction.

The fact that the CFTC and NFA are compelled to devote such substantial resources to protecting retail customers from widespread fraud in the off-exchange FX market is evidence enough that a serious problem exists with the CFMA that cries out for reform. In the aftermath of the *Zelener* decision, FX dealers can structure a margined currency contract for speculative use by retail customers and assert that is beyond the reach of the CFTC's jurisdiction. I don't believe that there is a single person in this room who would not agree that such contracts are futures contracts that deserve the protection of the CFTC. Under the *Zelener* case, it does not matter what the dealer actually does or what the customer actually expects—a single sentence in the small print of the customer agreement denies the CFTC 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. If we only fix the FX problem, those operators will simply transfer their scams to orange juice, gold and heating oil. The CFTC's jurisdiction and its retail consumer protections will be reduced to irrelevance.

At a minimum, we need an amendment that will clarify that retail FX derivative trading systems that do not regularly settle contracts by delivery are subject to CFTC registration requirements, unless operated by banks or other financial institutions. To the extent that such systems are regulated by the CFTC, they should only be operated by designated contract markets or well capitalized and fully regulated FCMs. All intermediaries who serve the same function as CPOs, CTAs and IBs and who deal with retail customers of off-exchange FX trading systems, regardless of the identity of the operator or the platform, must be required to register in the appropriate capacity and be subject to comparable regulation.

Exempt Commodity Markets

Our perspective is based on "first principles," which means we look to the findings and purposes adopted by Congress to guide the Commission's exercise of its jurisdiction. Section 5(b) of the Commodity Exchange Act charged the Commission with a duty to oversee "a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals" and to "to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this chapter and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices."

There is a growing conflict between these "purposes" and the statutory exemption for Commercial Markets found in Section 2(h)(3), which is the basis for the Exempt Commercial Market ("ECM") category. It is clear that all of the key purposes mandated by Congress in Section 5(b) are jeopardized if trading facilities for contracts in exempt commodities are permitted to coexist with regulated futures exchanges that list those same commodities. The Exempt Commercial Markets authorized by Section 2(h)(3), do not have any system of "effective self regulation" of their facilities or of their market participants. Their contracts are traded based on the prices of commodities that have limited supplies and that have often been the subject of manipulative activity and disruptive market behavior. There is no mechanism in place "to deter and prevent price manipulation or any other disruptions to market integrity." The Commission cannot track the build-up of dominant positions. The ECM has no real power over its users. At best, the Commission has power to punish such conduct after the fact. We find this to be a serious problem, as explained in detail below, that is at odds with Congress's intent behind the CFMA and which, if left unaddressed, is likely to jeopardize the public's confidence in the CFTC's ability to do its job.

A. Trading standardized, cash settled, fungible commodity contracts on a multilateral execution facility is indistinguishable from futures trading.

Bilateral swaps, including swaps respecting energy, metals and other non-agricultural products, as defined at section 2(g) of the CEA, were excluded from the exchange trading requirement of the CEA because they had developed into an important product and a formal confirmation of their excluded status was desirable. The Commission's Policy Statement Concerning Swap Transactions, 54 *Fed. Reg.* 30,694 (July 21, 1989) was the first step in the direction of excluding financial product swaps. The Futures Trading Practices Act of 1992, P.L. No. 102–546, 106 Stat. 3590, amended the CEA and clarified the Commission's authority to exempt certain transactions from the exchange trading requirement. The Commission adopted such regulations in 1992, e.g., 17 C.F.R. 35. An excluded bilateral swap must be "subject to individual negotiation by the parties and not executed on a trading facility." [1]

CEA Section 2(d)(2) excluded electronically traded contracts based on certain financial measures that were deemed unlikely to be subject to manipulative activity (an "excluded commodity") if the contract is entered into on a principal-to-principal basis between eligible contract participants. This exclusion is based on the recommendations of the President's Working Group ("PWG"). The PWG carefully limited its recommendation for an excluded electronic trading platform to a class of commodities that did not include the types of commodities traded on an ECM:

> "Accordingly, the Working Group unanimously recommends that Congress amend the CEA to clarify that entering into or trading excluded swap agreements (i.e., agreements between eligible swap participants *that do not involve non-financial commodities with finite supplies*) through electronic trading systems with certain characteristics does not affect the status of the agreements traded through the system and does not provide a basis for regulation of the system. *Over-the-Counter Derivatives Markets and the Commodity Exchange Act,* Report of The President's Working Group on Financial Markets, at 18–19 (November 1999) (emphasis supplied)

CME supported and continues to support those portions of the CFMA that exclude bilateral swaps in financial commodities. We also support the electronic trading of financial derivatives on Exempt Boards of Trade as provided in CFMA. But, the contracts traded on ECMs are not such bilateral swaps. They are standardized derivatives whose terms are set by the operator of the trading platform. Identical contracts become fungible if the platform provides central counterparty clearing. Consequently a buyer can offset his position by selling an equal and opposite contract. The price of the transaction is set at the time of the transaction but delivery is deferred. We do not consider these to be forward cash contracts because they are not regularly settled by the delivery of a specific cash instrument; rather they are cash settled like many financial futures contracts.

The only significant differences between traditional DCMs and ECMs is the "eligible contract participant" ("ECP") qualification of the ECM's customers and the requirement that ECM customers execute transactions without a broker or other intermediary. However, it is only those traders that are large enough to satisfy the ECP requirements who are likely to be involved in manipulative activity. Of course, CME Group Exchange customers can also directly enter their orders into the GLOBEX trading system and most customers do qualify as eligible contract participants. That difference may justify a different set of customer protection rules for ECMs, but it does not justify the lack of a self-regulatory system, large trader reporting or information sharing with other exchanges.

B. Coexisting regulated and unregulated markets for economically equivalent commodity contracts impair information flows necessary to prevent misconduct.

Large trader reports are the key element of Commission and self-regulatory organization surveillance programs to prevent disruptive market activities. ECMs do not require large trader reports and do not participate in the Intermarket Surveillance Group, which shares information across exchanges. There is no logical basis for this distinction. If the prevention of disruptive market behavior is to remain a goal of derivatives regulation, information collection and sharing is essential.

The intensity of concern respecting this lack of information depends on the likelihood of manipulation or other market disruptions that may be caused by trading particular underlying products, i.e. excluded *versus* exempted commodities. Again, the 1999 PWG report is instructive. The PWG's recommendations for eliminating the exchange trading requirement and easing regulatory burdens on electronic trading facilities, which host transactions involving derivatives based on excluded commodities, were premised on its considered judgment respecting the risks of manipulative and market distorting activity in the excluded commodities:

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[1] (g) Excluded swap transactions

No provision of this chapter (other than section 7a (to the extent provided in section 7a(g) of this title), 7a–1, 7a–3, or 16(e)(2) of this title) shall apply to or govern any agreement, contract, or transaction in a commodity other than an agricultural commodity if the agreement, contract, or transaction is—

(1) entered into only between persons that are eligible contract participants at the time they enter into the agreement, contract, or transaction;
(2) subject to individual negotiation by the parties; and
(3) not executed or traded on a trading facility.

"Where regulation exists, it should serve valid public policy goals. The justifications generally cited for regulation of the futures markets include the goals of protecting retail customers from unfair practices, protecting the price discovery function, and guarding against manipulation. With similar policy goals in mind, the Working Group has recommended limiting the proposed exclusion for swap agreements to eligible swap participants trading for their own account . . . . *It has also recommended limiting proposed exclusions to markets that are not readily susceptible to manipulation and that do not currently serve a significant price discovery function.*" *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, Report of The President's Working Group on Financial Markets, at 22 (November 1999) (emphasis supplied)

The PWG made it abundantly clear that trading facilities for energy and metals products should not be exempted:

"Due to the characteristics of markets for non-financial commodities with finite supplies, however, the *Working Group is unanimously recommending that the exclusion not be extended to agreements involving such commodities.* For example, in the case of agricultural commodities, production is seasonal and volatile, and the underlying commodity is perishable, factors that make the markets for these products susceptible to supply and pricing distortions and to manipulation. There have also been several well-known efforts to manipulate the prices of certain metals by attempting to corner the cash or futures markets. Moreover, the cash market for many non-financial commodities is dependent on the futures market for price discovery." Id. at 16 (emphasis supplied)

The testimony adduced at the recent Congressional hearings on the Amaranth episode and energy trading issues confirms the validity of the PWG's concerns about an exclusion for energy trading facilities.

C. The Remedy: The Section 2(h)(3) exemption for unregulated commercial markets should be eliminated.

Potential disruption of regulated markets and the cash market for certain exempted commodities justifies an increase in the flow of current information from organized OTC markets to the Commission. One seemingly simple solution is to change reporting requirements. Our experience suggests that this will be a failure. In order to provide accurate reports, a market needs an effective surveillance and compliance system. This implies that an effective system of self regulation must be put in place. The logical conclusion is you must implement at least the core principles required of a Designated Transaction Execution Facility ("DTEF") to get a useful result.

The 2(h)(3) special exemption for commercial markets trading commodity futures contracts based on energy, metals and other non-enumerated commodities is directly contrary to the recommendations of the President's Working Group on which CFMA was based. The PWG expressly found that an exemption for exchange-like trading of derivatives based on underlying commodities that were not immune from manipulation was not appropriate. The legislative history of the CFMA provides no explanation for why Congress deviated from the PWG recommendations.

If Congress needs any further justification for taking action to reverse this hole in the CEA's regulatory safety net, Intercontinental Exchange's Jeffrey Sprecher's recent testimony before Congress adequately confirms that there is ample need for it now. He conceded that it is essential to the performance of the CFTC's oversight function that there be enhancements "to the quality and quantity of information currently available to the CFTC and, in particular, its ability to integrate data from ICE and NYMEX."[2] Additionally, our sense is that the CFTC devotes an outsized proportion of its human and financial resources to trying to stay abreast of problems in the ECM market and dealing with other off-exchange trading. Eliminating the 2(h)(3) category would produce significant efficiencies of administration and more effective regulatory oversight without any adverse implications for innovation, competition or market flexibility. Any trading facility that is now successfully operating as an ECM can easily and inexpensively convert to a DTEF or DCM. Beyond the market protections reflected in a DTEF's core principles, a DTEF has an affirmative obligation to deter market abuses and to implement systems and procedures to comply with that obligation.[3] The Commission has oversight powers to insure that the

[2] Testimony of Jeffrey C. Sprecher, Chairman and Chief Executive Officer, IntercontinentalExchange, Inc., Before the House Agriculture Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, page eight (July 12, 2007).

[3] CEA Section 5a(c)(2) provides as follows:

Deterrence of abuses.—

obligation is met. The existing DTEF regulatory scheme would appear to provide an effective remedy to the problems identified with ECMs without the need to invent something new.

The Commission's published list of ECMs confirms our belief that there appears to be no barrier for ECMs to convert to DTEFs or DCMs. There are numerous providers to whom any servicing needs, such as clearing and/or compliance, can be outsourced efficiently. The significant entrants, such as ICE, ChemConnect, Inc., Chicago Climate Exchange, Inc., and TradeSpark have affiliates that are already regulated by the Commission and can provide such services in house. HoustonStreet seems to be a marketplace for physical crude oil and other refined products that makes certain NYMEX ClearPort products available in a linkage arrangement. NetThruPut Inc. appears to be a cash crude oil trading system. It is unclear, from its websites, what ICAP is actually doing as an ECM. Some, such as Optionable, Inc. and Commodities Derivative Exchange, Inc., are out of business. Others appear to be trading agricultural commodities like pulp and salmon, which, not being exempt commodities, are not within the purview of ECMs.

Security Futures Products

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 the success and acceptance of the contract in European markets, single stock futures can be a great product with enormous benefits to market users. 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.[4]

Transaction Tax

The periodic attempts to impose a transaction tax on exchange traded futures contracts are misguided. First, the tax will fall on liquidity providers who will simply be driven off shore to untaxed exchanges. Second, the regulated exchanges already pay for the Commission's direct oversight and their customers pay a fee to the National Futures Association for the services it performs, many of which have been offloaded from the CFTC. Finally, the CFTC's expenses and need for additional staff is attributable to off-exchange frauds and manipulations, not self-regulated exchange trading.

The board of trade shall establish and enforce trading and participation rules that will deter abuses and has the capacity to detect, investigate, and enforce those rules, including means to—

(A) obtain information necessary to perform the functions required under this section; or

(B) use technological means to—

(i) provide market participants with impartial access to the market; and

(ii) capture information that may be used in establishing whether rule violations have occurred.

[4] In their letter to Congressional leaders dated November 3, 2005, the PWG principals stated *inter alia* that: "In addition to retail foreign currency fraud issues, the PWG members have discussed the complex issues related to . . . the implementation of risk-based portfolio margining systems for security futures products and security options . . . As part of these discussions, the PWG is committed to resolving the portfolio margining system and narrow-based index issues within the time frames set forth below:

With regard to portfolio margining, the SEC has committed to approving self regulatory organization (SRO) rules that permit the use of risk-based portfolio margining methodology to determine margin requirements for portfolios that include security futures products and for security options by June 30, 2006. In the event that the SEC does not approve such SRO rules, the SEC will promulgate rules to permit risk-based portfolio margining for security options by September 30, 2006, and the SEC and CFTC will do so jointly for security futures products by the same date."

Each year we are faced with a proposal to fund the Commodity Futures Trading Commission's budget with a "transaction tax" levied on U.S. futures exchange trading. This tax will: (1) impair liquidity of U.S. futures markets; (2) change the competitive balance in favor of foreign and OTC markets; (3) unfairly burden U.S. futures exchanges with the costs of policing OTC fraud; (4) hurt the local economies in the cities and states where futures exchanges create great employment opportunities; (5) lessen the value of the information provided to farmers and the financial services industry by means of the price discovery that takes place in liquid, transparent futures markets; (6) adversely impact the cost of financing the national debt; and, ironically, (7) fail to increase the taxes actually collected. Fortunately, with the Agriculture Committee's leadership, Congress has consistently rejected this ill-conceived tax proposal.[5] A transaction tax is ill-conceived and counter-productive and should be rejected for all of the reasons listed, as explained in more detail below:

1. Adversely Impacting Liquidity: We estimate that the transaction tax will add significantly to the execution costs of the significant liquidity providers on U.S. futures exchanges. These market makers whose constant participation and rapid turnover is the major source of market liquidity operate on razor thin margins. Every market maker would pay an additional tax on top of his existing Federal, state and local taxes. A transaction tax to fund the CFTC imposes millions per year in tax on market makers in addition to the tax they already pay on any profits they achieve. The transaction tax is imposed whether or not they actually profit. Many of these market makers are at the margin of profitability. This significant tax will expose them to the choice of continuing at a profit level unjustified by the risks assumed or exiting the business. The exit of liquidity providers means decreased efficiency of the futures markets, more volatility and less facility for other market participants to make effective use of futures markets. We are also concerned that the discipline exerted on the agency's budget by the appropriations process will evaporate under a regime where the costs are allocated to certain market users.

2. Upsetting the Competitive Balance: The transaction tax only applies to domestic futures exchange trading: competing over-the-counter markets, including the ECMs that are discussed above, and foreign futures exchanges are not covered. This feature grants those venues substantial, unearned competitive advantages over U.S. regulated futures exchanges. Users of U.S. futures markets can and do readily shift their business off-exchange or overseas if U.S. futures markets are too costly. In this era of electronic trading, market participants can transfer their business to trading platforms that offer the most competitive transactional pricing. It is as easy for an exchange to claim a foreign venue and avoid costly U.S. regulation or taxes. This is not a remote possibility, it is happening now in connection with the major competitive battle between a U.S. and U.K. energy futures market.

3. Taxing the Wrong Parties: Futures exchanges already pay for direct supervision by the CFTC. Customers trading on U.S. futures exchanges pay a fee to cover the regulation of intermediaries provided by the National Futures Association, which has taken over many of the responsibilities of the CFTC. A significant and increasing amount of CFTC's enforcement and surveillance budget is dedicated to detecting and prosecuting fraud in OTC trading (for example, OTC currency and energy trading), yet this transaction tax proposal would have exchange traders foot the bill for CFTC's OTC-related surveillance and enforcement activities. So too, trading done through foreign exchange affiliates of U.S.-based OTC entities would similarly escape the ambit of the transaction tax even while CFTC would be dedicating its staff resources to surveillance and enforcement activities related to those markets.

4. Hurting Local Economies: Harming the U.S. futures industry will affect both the U.S. and local economies. In Chicago, the exchange industry provides more than 100,000 direct and indirect jobs; more than $48 billion are on overnight deposit in Chicago and New York banks as a result of the exchanges. The exchanges and those who depend on them for their livelihoods are the source of millions of dollars in Federal, state and local tax revenues. New York benefits just as directly from its three futures exchanges, with billions contributed to NYC's economy and hundreds of millions in Federal state and local taxes.

5. Impairing Price Discovery: Futures markets provide significant benefits to market users and to persons seeking good information on future pricing in order to guide their decision making on investment, planting, herd management, etc. The

[5] In its March 1, 2007 budget recommendation letter, the bi-partisan leadership of the House Agriculture Committee stated: "The Administration has also proposed the enactment of new user fees to be charged by a number of different agencies under the jurisdiction of the Committee on Agriculture. Some of these fees have been proposed before, and it has been the consistent judgment of our Committee that the widespread benefits of the activities involved justify the use of the general treasury."

deeper and more liquid the market, the better the price discovery and information provided. Any impairment of liquidity lessens the value of the information and the functioning of our market based economy.

6. Increasing the Cost of Financing the National Debt: The value to the Federal Government of liquid, efficient domestic futures markets far exceeds the revenue that might be generated by the transaction tax. Liquid futures markets save the Treasury and taxpayers millions of dollars by allowing government securities dealers effectively to hedge their risks and to bid more aggressively at auctions for Treasury securities. The savings to the Treasury in interest rate payments are worth far more than the $127 million the transaction tax is expected to raise. If a government-imposed transaction tax diminishes liquidity in futures markets, thereby increasing government borrowing costs by even one basis point, that tax would increase the Federal deficit by at least $474,543,158.71 million per year.

7. Securing No Real Gain in Revenues: In every instance when a government imposed a transaction tax on futures trading, the loss of business to foreign exchanges forced a reversal. In some cases it came too late and the industry was lost. If the proposed transaction tax forces the U.S. futures business overseas or to untaxed substitute markets, the anticipated revenue will be an illusion. Diminished futures industry business and employment will also result in reduced corporate and personal income taxes in this country. Not only will the proposed transaction tax fail to produce enough ongoing revenue to fund the CFTC, but it will reduce government revenues generally.

V. Conclusion

The CME, its members and their customers, and the nation's market based economy have prospered under the CFMA. The CFTC should be reauthorized and the principles of CFMA should be reaffirmed. The CME looks forward to engaging significantly in the reauthorization process and to achieving legislation that maintains the significant successes of the CFMA while making discreet corrections designed to materially improves the utility, efficiency, competitiveness and fairness of our futures markets for our customers and all market participants.

Mr. ETHERIDGE. Thank you, Mr. Duffy. And if the other Members would suspend for just a minute. We have been joined by the Ranking Member of the full Committee, if he has comments for an opening statement.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. ETHERIDGE. We would gladly recognize you this morning.

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

Mr. GOODLATTE. The only thing I will say is that I very much appreciate your holding this hearing, that we have been long working on the effort to reauthorize this important legislation, so I am pleased to be here to hear the testimony of the witnesses and have them help us find a way forward. I welcome all members of this panel.

Mr. ETHERIDGE. Thank you, sir. Dr. Newsome.

STATEMENT OF JAMES E. NEWSOME, PH.D., PRESIDENT, CEO, AND MEMBER, BOARD OF DIRECTORS, NEW YORK MERCANTILE EXCHANGE, INC., NEW YORK, NY

Dr. NEWSOME. Thank you, Mr. Chairman. Mr. Chairman, Mr. Moran, Members of the Committee, as President and CEO of the New York Mercantile Exchange, I appreciate the opportunity and the invitation to share our views today. The CFMA has provided critically needed legal certainly and modernization to U.S. futures and derivatives markets. The CFMA also provides a well-considered oversight framework for futures markets that has enhanced the abilities of NYMEX and the other regulated exchanges to operate in a rapidly changing business environment.

The CFMA shifted away from a "one-size-fits-all" prescriptive approach to a more flexible approach that included the use of core principles for DCMs or Designated Contract Markets. In today's competitive global environment, this shift is more important now than ever before. In addition, the CFMA strengthened the CFTC's role as an oversight regulator. The CFMA's flexible regulatory framework provides benefits to the marketplace while continuing to ensure confidence in the integrity of futures markets.

However, with an ever evolving marketplace, some markets differ dramatically now than just 7 years ago, causing the need for this Committee's reevaluation of certain aspects of the CFMA. The CFMA established an unregulated market category, the exempt commercial market, and due to evolution of some markets, non-regulation of certain ECM markets can no longer be justified. Over the last several months, the role of ECMs has received a great deal of scrutiny in Congress and elsewhere. Prior to and during this period, NYMEX has observed and voiced a broad and growing consensus that certain products traded on ECMs and DCMs are tightly linked and effectively comprise one broader market.

Consequently, NYMEX, along with others, have concluded that there is a need for appropriate statutory change to provide effective regulatory oversight of markets that are of critical importance to U.S. consumers and to the overall economy. The debate over the changes in the marketplace is now largely settled. The real question becomes the appropriate statutory response. Mr. Chairman, today's timely hearings provides an opportunity for the Congress, the CFTC and the industry to begin to work together constructively on developing a solution.

It has become apparent to me that the structural issues raised by changes in the marketplace cannot be addressed effectively at the level of individual exchanges. NYMEX believes that a targeted approach that directly addresses the specific issues raised by these industry changes would be the most effective policy response and would provide the greatest assurance of limiting the unintended consequences of broader changes.

NYMEX believes that a heightened level of CFTC oversight should be mandated for certain products listed on ECMs whose products are directly linked to regulated markets. However, NYMEX does not believe that the case has been made for extending such heightened regulation to other products listed on such an ECM to other ECMs that have not triggered these policy interest and concerns or the traditional bilateral OTC marketplace.

Specifically, for those products trading on ECMs that have triggered public policy interest and concerns, NYMEX believes that the CEA should be amended to mandate routine large trader reporting and position accountability requirements for financially settled ECM contracts that are highly linked and functionally equivalent to regulated DCM contracts. Such ECMs must also be assigned self-regulatory responsibilities to police their own markets and to submit applicable rule changes to the CFTC.

Finally, over 30 years ago, Congress very wisely gave the CFTC exclusive statutory authority over the regulation of futures transactions. This exclusive authority has been reaffirmed by Congress in every subsequent reauthorization of the CEA. It has also established case law in the Federal courts. NYMEX believes strongly that the CFTC currently has and should continue to have exclusive authority and jurisdiction over futures transactions and futures markets. To vary from this prudent regulatory structure would create confusion, inconsistency and uncertainty, ultimately harming the vitality and effectiveness of derivatives markets, as well as the broader economy relying upon such markets for both price discovery and the hedging of risk. Thank you, Mr. Chairman.

[The prepared statement of Dr. Newsome follows:]

PREPARED STATEMENT OF JAMES E. NEWSOME, PH.D., PRESIDENT, CEO, AND MEMBER, BOARD OF DIRECTORS, NEW YORK MERCANTILE EXCHANGE, INC., NEW YORK, NY

Mr. Chairman and Members of the Committee, my name is Jim Newsome and I am the President and Chief Executive Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products, and has been in the business for more than 135 years. NYMEX is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC) both as a "derivatives clearing organization" (DCO) and as a "designated contract market" (DCM).

These categories of regulated entities were established by the Commodity Futures Modernization Act of 2000 (CFMA), which amended the Commodity Exchange Act (CEA or the Act). The CFMA provided greater legal certainty for over-the-counter (OTC) derivatives transactions and established a number of other new statutory categories for trading facilities. On behalf of the Exchange, its Board of Directors and shareholders, I want to express our appreciation to the Committee for holding today's hearing on the reauthorization of the CFTC.

Overview

The CFMA is 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 CFMA provides a well-considered oversight framework for futures markets that has enhanced the abilities of NYMEX and the other regulated exchanges to operate in a rapidly changing business environment. The CFMA's flexible regulatory framework also provides competitive benefits to the marketplace while continuing to ensure confidence in the integrity of our markets. The Exchange further believes that the tiered statutory structure for trading facilities has been effective in many respects.

However, with an ever-evolving market place, today's markets differ dramatically from only 7 years ago, causing the need for this Committee's reevaluation of certain aspects of the CFMA. The CFMA established an unregulated market category, the exempt commercial market (ECM), and due to the changes in the market place, nonregulation of certain ECMs can no longer be justified.

Over the last several months, the role of ECMs has received a great deal of scrutiny in Congress and elsewhere. During this period, NYMEX has observed a broad and growing consensus that certain products traded on ECMs and DCMs are tightly linked and effectively comprise one broader market. Consequently, NYMEX, along with some legislators and regulators, have concluded that there is a need for appropriate statutory change to provide effective regulatory oversight of markets that are of critical importance to U.S. consumers and to the overall economy. The debate over the changes in the marketplace is now largely settled. The real question becomes the appropriate statutory response. Today's timely hearing provides an opportunity for Congress, the CFTC and the industry to begin to work together constructively on developing a solution.

Finally, over thirty years ago, Congress unambiguously gave the CFTC exclusive statutory authority over the regulation of futures transactions. This exclusive authority has been continually reaffirmed by Congress in every subsequent reauthorization of the CEA and is also established case law in the Federal courts. NYMEX believes strongly that the CFTC currently has and should continue to have exclusive authority and jurisdiction over futures transactions and markets. To vary from this prudent regulatory structure would only create confusion, inconsistency and uncertainty, ultimately harming the vitality and effectiveness of derivatives markets as well as the broader economy relying upon such markets for price discovery and hedging of risk.

I. The CFMA, by all indicators, is providing a reasonable, workable, and effective oversight regime for the regulated exchanges.

The CFMA provides a well-considered, flexible regulatory 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 the abilities of domestic exchanges to compete with foreign exchanges operating in the U.S. and abroad and with unregulated over-the-counter markets. 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 CFMA shifted away from a "one-size-fits-all" prescriptive approach to futures exchange regulation to a more flexible approach that included the use of "Core Principles" for DCMs. In addition, the CFMA confirmed the CFTC's role as an oversight agency (rather than a "command and control" agency that must issue affirmative approval before any new innovations could be introduced to the market). Congress largely replaced extremely detailed, prescriptive regulation with more broadly structured "Core Principles" for regulated markets. Under the Core Principles approach, Congress sets broad performance standards that must be met by the regulated entity, while enabling the entity to have flexibility with regard to how it complies with these standards. Thus, the CFMA 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.

As a result of the flexible Core Principles approach to regulation, the Exchange can respond rapidly to changing markets by introducing new risk management products, which benefit a broad spectrum of market participants. Market participants have also benefited from recent increased volume levels at all exchanges, which further emphasizes the exchanges' need to be able to respond quickly to market participants' risk management needs. As a result of Congress' foresight and innovation, such improvements can be implemented, subject to CFTC review and oversight, without protracted approval processes. CFTC staff periodically undertakes reviews to assess the adequacy of self-regulatory programs and NYMEX has consistently been deemed to have maintained adequate regulatory programs in compliance with its obligations as a self-regulatory organization (SRO) under the CEA.

The CFMA also created several new market tiers. The tiered structure was intended to impose a degree of regulation necessary to the market place based on the product traded and the market participants. Thus, at the highest tier of regulation, the DCM category, 18 core principles apply on an ongoing basis and the market is open to all products and all market participants and trades are or can be intermediated.

The derivatives transaction execution facility (DTEF) is at the second tier of regulation and is subject to nine core principles. The market generally can trade products that are highly unlikely to be susceptible to manipulation, and it is not open to all market participants. Under one version of the DTEF, market participants must be eligible contract participants or trade through a registered FCM with net capital of at least $20,000,000. Under the other version of DTEF, participants are limited to eligible commercial entities. The DTEF category to date has not been utilized by the derivatives industry.

The third market tier, for exempt markets, includes ECMs and Exempt Boards of Trade (EBOT). EBOTs generally are limited to excluded commodities and are unregulated. The ECM tier is open only to eligible commercial entities, trades products other than financial derivatives and agricultural commodities and also, as a facility, is completely unregulated. Transactions on the ECM are subject only to the CFTC's antifraud and anti-manipulation authority. To date, 20 entities have filed notification with the CFTC of their intention to operate as an ECM, and approximately six companies have filed notification of their intention to operate as an EBOT.

II. The current statutory structure no longer works for certain markets operating as ECMs.

The CFMA was enacted following the issuance of a report by the President's Working Group on Financial Markets (PWG) that was undertaken at the direction of Congress to examine OTC derivatives markets and to provide legislative recommendations to Congress. The PWG Report, entitled "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," was issued in 1999 and focused primarily on swaps and other OTC derivatives transactions executed between eligible participants. Among other things, the PWG Report recommended exclusion from the CEA for swap transactions in financial products between eligible swap participants. Yet, the PWG Report explicitly noted that "[t]he exclusion should not extend to any swap agreement that involved a non-financial commodity with a finite supply." (Report of the PWG, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act" (November 1999) at p. 17.). However, in a footnote, the PWG stated that "[t]he CFTC would retain its current exemptive authority for swap agreements that involve a non-financial commodity with a finite supply." (Id.).

The CFMA added new section 2(h) to the CEA, which exempted energy commodities from CFTC regulation and allowed the trading of energy swaps on an electronic trading platform. Section 2(h) was intended to provide legal certainty to energy swaps traded on or off a trading facility by clarifying that bilateral contracts, agreements or transactions in exempt commodities between eligible commercial entities were not subject to CFTC regulation, even if the contracts were cleared, but remained subject to the CFTC's anti fraud and anti manipulation provisions. The CFTC implemented Section 2(h)(3) in Part 36 of its regulations by creating the category of markets known as ECMs. While transactions executed on an ECM generally are subject to anti-fraud and anti-manipulation authority, the ECM itself is essentially exempt from all substantive CFTC regulation and oversight. In addition, the ECM by statute has no affirmative requirements to engage in any self-regulatory activities to monitor its markets or otherwise seek to prevent any manner of market abuses.

The ECM category was designed for commercial market participants who were in the business of making and taking delivery of the physical product, and who would be limited to engaging in principal-to-principal trading with each other. The exemption from effective CFTC oversight and regulation of the ECM trading facility built on the CFTC's existing 1993 Energy Exemption for OTC bilateral energy swaps between commercial entities. There was a view at the time that there was not a public policy need to protect large commercial participants from transactions with other large and similarly situated commercial entities. However, the large-scale exemption of ECMs from effective CFTC oversight did not contemplate that the trading activities of commercial players on such trading facilities eventually would have spill-over or ripple effects on the broader regulated energy markets and ultimately affect consumers.

A series of profound changes have occurred in various OTC markets since the passage of the CFMA, including technological advances in trading, such that NYMEX, the regulated DCM, and the IntercontinentalExchange (ICE), an unregulated ECM, have become highly linked trading venues. As a result of this phenomenon, which could not have been reasonably predicted only a few short years ago, the current statutory structure no longer works for certain markets now operating as ECMs.

Specifically, the regulatory disparity between the NYMEX and the ICE, which are functionally equivalent, has created serious challenges for the CFTC and for NYMEX in its capacity as a self-regulatory organization. NYMEX also has concluded that ECMs, such as ICE, which function more like a traditional exchange and which are linked to an established exchange, should be subject to regulation of the CFTC for certain products in the form of large trader reporting, position limits/accountability levels and self-regulatory responsibilities.

In addition, the continuing exchange-like aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs, such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple implications for other clearing members and for various clearing organizations that share common clearing members. Consequently, legislative change is necessary to address the real public interest concerns created by the current structure of the OTC electronically-traded natural gas market and the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

Subsequent to the passage of the CFMA in late 2000, derivatives markets, especially natural gas derivatives markets, evolved in just a few short years to an extent and at a rate that would have been very difficult to predict in 2000. For example, when the CFTC was in the midst of proposing and finalizing implementing regulations and interpretations for the CFMA in 2001, even shortly following the wake of the Enron meltdown in late 2001, the natural gas market continued to be largely focused upon open outcry trading executed on the regulated NYMEX trading venue. At that time, NYMEX offered electronic trading on an "after-hours" basis, which contributed to only approximately 7–10% of overall trading volume at the Exchange. Electronic trading (of standardized products based upon NYMEX's natural gas contracts) was at best a modest proportion of the overall market. Moreover, it was more than 6 months following the Enron meltdown before the industry began to offer clearing services for OTC natural gas transactions.

However, in determining to compete with NYMEX, ICE, which as previously noted operates as an ECM, not only copied all of the relevant product terms of NYMEX's core or flagship natural gas futures contract, but also misappropriated the NYMEX settlement price for daily and final settlement of its own contracts. As things stand today, natural gas market participants have the assurance that they can receive the benefits of obtaining NYMEX's settlement price, which is now the established industry pricing benchmark, by engaging in trading either on the regulated NYMEX or on the unregulated ICE.

For some period of time following the launch of ICE as a market, ICE was the only trading platform that offered active electronic trading during daytime trading hours. In September of 2006, NYMEX began providing "side-by-side" trading of its products—listing products for trading simultaneously on the trading floor and on the electronic screen. Since that time, there has been active daytime electronic trading of natural gas on both NYMEX and ICE. The share of electronic trading at NYMEX as a percentage of overall transaction volume has shifted dramatically to the extent that electronic trading now accounts for 80–85% of overall trading volume at the Exchange.

The existence of daytime electronic trading on both NYMEX and ICE has fueled the growth of arbitrage trading between the two markets. Thus, for example, a number of market participants that specialize in arbitrage activity have established computer programs that automatically trade the spread between the two markets and that transmit orders to one market when there is an apparent price imbalance with the other market. As a result, there is now a relatively consistent and tight spread in the prices of the competing natural gas products. Hence, the two competing trading venues are now tightly linked and highly interactive and in essence are simply two components of a broader derivatives market. As the CFTC itself acknowledged in its recent proposed rule-making, there is now "a close relationship among transactions conducted on reporting markets and non-reporting transactions." (72 *Fed. Reg.* 34,413, at 34,414 (2007) (proposed June 22, 2007.)

Because ICE price data are available only to its market participants, NYMEX does not have the means to establish conclusively the extent to which trading of ICE natural gas swaps contributes to, influences or affects the price of the related natural gas contracts on NYMEX. However, a recent CFTC staff study provided confirmation that price discovery is occurring on both the ICE and the NYMEX trading venues. It is also clear that, as a consequence of the extensive arbitrage activity between the two platforms and ICE's use of NYMEX's settlement price, as well as other factors, the two natural gas trading venues are now tightly linked and highly interactive. These two trading venues serve the same economic functions and are now functionally equivalent.

NYMEX staff has been advised that, during most of the trading cycle of a listed futures contract month, there is a range of perhaps only five to twelve ticks separating the competing NYMEX and ICE products. (The NYMEX NG contract has a minimum price fluctuation or trading tick of $.001, or .01¢ per mmBtu.) NYMEX staff has also been advised by market participants who trade on both markets that a rise (fall) in price on one trading venue will be followed almost immediately by a rise (fall) in price on the other trading venue, whether the change in price be initiated on either NYMEX or ICE. These observations of real-world market activity along with the recent CFTC staff study support the conclusion that trading of ICE natural gas swaps do in fact contribute to, influence and affect the price of the related natural gas contracts on NYMEX. No one could have predicted in 2000, when the exemption was crafted for energy swaps, how this market would evolve.

The ICE market now holds a significant market share of natural gas trading, and a number of observers have suggested that most of the natural gas trading in the ICE Henry Hub swap is subsequently cleared by the London Clearing House, the clearing organization contracted by ICE to provide clearing services. Thus, there is now a concentration of market activity and positions occurring on the ICE market, as well as the exchange-like concentration and mutualization of financial risk at the clearing house level from that activity.

As previously noted, at the time that the CFMA was being formulated in Congress, the presumption was that larger, sophisticated market participants did not need a regulatory agency to protect them from trading with each other. Also, there were no perceived concerns at that time about potential impact on the public interest implicated by trading on ECMs. Yet, what has become clear in the last several years is that the changing nature and role of ECM venues, such as ICE, do now trigger public interest concerns in several ways, including with respect to the multiple impacts on other trading venues that are regulated, as well as through the exchange-like aggregation of financial risk.

The CFMA, however, did contemplate the possibility of ECMs becoming price discovery markets and, accordingly gave the CFTC authority to make the determination that an ECM performed a significant price discovery function and to require the dissemination of prices, trading volume and other trading data. This authority has never been exercised despite the tremendous growth in the volume of trading in the natural gas contract on ICE and the clear linkage between that market and the NYMEX. In recent public statements at both the staff and the Commission level, there have been indications from the CFTC that the price discovery criteria initially established by CFTC rules in 2004 may have become outdated. Consequently, CFTC staff is now reviewing those standards and considering whether to replace them with newer criteria that more appropriately capture the current marketplace reality.

NYMEX does not have any ongoing formal relationship with ICE. In particular, as ICE and NYMEX are in competition with each other, there are currently no arrangements in place, such as information-sharing, to address market integrity issues. NYMEX as a DCM does have affirmative self-regulatory obligations; ICE as an ECM has no such duties. Yet, from a markets perspective, the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive; trading activity and price movement on one venue can quickly affect and influence price movement on the other venue.

As one case example of concerns created for NYMEX as a DCM because of the differences in the level of regulation, NYMEX staff was aware of and monitored all open positions that Amaranth maintained in NYMEX trading venues, including the physically delivered NG natural gas futures contract. NYMEX conducted regular reviews of Amaranth's open positions in excess of position accountability levels prescribed by NYMEX rule. NYMEX staff members directed Amaranth in early August 2006 to reduce its open positions in the first two nearby contract months based upon what they believed to be a significant concentration in NYMEX markets in Natural Gas (relying upon an NG "futures only" approach). NYMEX believes that such a directive was prudent and also was effective with respect to reducing positions carried on our platform.

As noted, NYMEX maintains no information sharing agreement of any kind with ICE; the Exchange also observes that, during the period in question, the CFTC was not receiving any regular information from ICE as to positions on its platform. Thus, a shift of positions by Amaranth from NYMEX to ICE was undetectable at that time both by NYMEX and the CFTC. NYMEX believes that the outdated provisions of the CEA concerning ECMs do raise concerns not only for DCMS and for regulators but also for market participants and indeed for the general public as a whole.

While the dissemination of market data from ICE would be useful, the CFTC's existing statutory authority does not go far enough in order to address the significant regulatory problems identified by the Amaranth case. Thus, a legislative change is required to give the CFTC a certain level of authority over these markets as needed to address the identified public interest concerns.

It has become apparent to NYMEX that the broad structural issues raised by changes in the marketplace cannot be addressed effectively at the level of individual exchanges. For example, earlier this year, in an effort to cooperate with the Federal Energy Regulatory Commission (FERC) and following consultation with CFTC staff, NYMEX issued a compliance advisory in the form of a policy statement related to exemptions from position limits in NYMEX Natural Gas (NG) futures contracts. NYMEX adopted this new policy on an interim basis in a good faith effort to carry out its self-regulatory responsibilities and to address on an individual exchange level the market reality demonstrated by Amaranth's trading on both regulated and unregulated markets.

However, this experience has had an adverse impact on NYMEX's trading venues and is seemingly creating the result of shifting trading volume (during the critically important NG closing range period at NYMEX on the final day of trading) from our regulated trading venue to unregulated trading venues. Specifically, the new interim policy implemented by NYMEX on a good-faith basis has: (1) reduced volume on NYMEX during the critical 30 minute closing range period; (2) presumably shifted volume from the regulated to the unregulated trading venues; and (3) failed to solve the structural imbalances brought to light by Amaranth's trading. In addition, this policy could create new problems by diminishing the vitality of the natural gas industry's pricing benchmark. Consequently, NYMEX now believes strongly that legislative change is both necessary and appropriate.

NYMEX believes that a targeted approach that directly addresses the specific issues raised by these industry changes would be the most effective policy response and would provide the greatest assurance of limiting the unintended consequences of more sweeping or draconian changes. Thus, NYMEX believes that a heightened level of CFTC regulation and oversight should be mandated for certain products listed on a particular ECM triggering the public policy concerns noted above. NYMEX does not believe that the case has been made for extending such heightened regulation to other products listed on such an ECM, to other ECMs that have not triggered these policy interests and concerns, or to the traditional bilateral OTC market.

In particular, for those products trading on ECMs that have triggered public policy interests and concerns, NYMEX believes that the CEA should be amended to require routine mandated large trader reporting and position accountability requirements for financially settled ECM contracts that are highly linked to and functionally equivalent with regulated DCM contracts. Such ECMs also must be assigned self-regulatory organization duties to police their own markets and to submit applicable rule changes to the CFTC in a manner similar to other regulated entities; the CFTC also should have clear authority to address any failures by the ECM to comply with such requirements. NYMEX believes strongly that such statutory changes are necessary and appropriate and would not negatively impact the core price discovery and hedging functions provided by derivatives markets.

At present, the greatest attention has been focused upon energy products listed by ECMs. NYMEX does not believe it would be appropriate to exclude products by category from heightened regulation, as markets may evolve for other products, such as metals, biofuel or weather derivatives, in a manner similar to the evolution of energy markets.

The targeted approach that NYMEX recommends should not unduly affect the ability of ECMs to be sources of innovation, including with respect to the adoption of new trading technologies. This targeted approach may result in an ECM needing to distinguish on its electronic trading system those products that are subject to CFTC oversight from those products that remain exempt from CFTC regulation. However, more generally, NYMEX's recommended approach would not appear to require whole-sale changes in an ECM's business model.

It has been suggested that any manner of regulation of an ECM would lead immediately to the shift of trading elsewhere, either to the traditional bilateral OTC market or to less-regulated foreign boards of trade. NYMEX believes that this prospect is improbable for several reasons: (1) market participants will continue to be attracted to markets that offer pools of liquidity for trading in their products; (2) market participants appear to have a preference for the speed and efficiency of electronic trading as compared to the traditional phone bilateral market; and (3) electronic trading systems facilitate the clearing of traded products, which also seems to be the growing preference for OTC participants in a variety of products. Consequently, NYMEX believes that the hypothetical prospect of a worst-case scenario should not be misused to dissuade Congress or the CFTC from undertaking carefully considered and targeted solutions that can effectively fix the current shortcomings of the existing statutory structure.

III. The CFTC has exclusive jurisdiction over futures transactions and markets.

Since the original passage of the CEA, the CFTC has had clear and unambiguous exclusive authority over futures transactions and markets. When the CEA was first enacted, Congress provided that the CFTC have "**exclusive** jurisdiction. . . . with respect to accounts, agreements and transactions involving contracts of sale of a commodity for future delivery." 7 U.S.C. § 2(a)(1)(A) (emphasis added.) Moreover, the legislative history is quite clear as to Congress' legislative intent: "(a) the Commission's jurisdiction over futures markets or other exchanges is exclusive and includes the regulation of commodity accounts, commodity trading agreements, and commodity options; (b) the Commission's jurisdiction, where applicable, supersedes state as well as Federal agencies. . . ." Sen. Rep. No. 93–1131, 93rd Cong., 2d Sess., (1974) U.S.C.A.N. p. 48. In particular, Congress expressly made clear that the CFTC's jurisdiction over futures transactions and markets was to "avoid unnecessary, overlapping and duplicative regulation." 120 Cong. Rec. H34, 736 (Oct. 9, 1974).

The Federal courts have consistently upheld and affirmed this exclusive jurisdiction. Thus, for example, the U.S. Seventh Circuit Court of Appeals observed that the purpose of the CEA was to place the futures markets "under a uniform set of regulations." *Am. Agric. Movement, Inc.* v. *Board of Trade of the City of Chicago*, 977 F. 2d 1147, 1155–57 (7th Cir. 1992).

The Energy Policy Act of 2005 (EPAct) provided the FERC for the first time with enforcement powers in the form of anti-manipulation authority over transactions in connection with its jurisdictional entities. In addition, the EPAct directed that FERC establish a memorandum of understanding with the CFTC to work together cooperatively and to share information. It is interesting to note that, in that memorandum of understanding, the FERC specifically acknowledged that the CFTC: "has **exclusive** jurisdiction with respect to accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery. . . ." (emphasis added.)

More recently, FERC appears to have interpreted its new found authority expansively in a manner that encroaches upon the CFTC's exclusive authority over transactions executed on futures exchanges. FERC argues that its jurisdiction includes authority over futures contracts that serve as a price reference for cash transactions which are entered into by its jurisdictional entities. The effect of this broad construction (of the language in EPAct granting FERC anti-manipulation authority over cash market transactions) is the elimination of the CFTC's exclusive jurisdiction over futures market transactions. Thus, the latest FERC position is clearly inconsistent with the plain meaning of the CEA's exclusivity provisions. It is also inconsistent with the general understanding of the terms of the memorandum of understanding that FERC negotiated and ultimately executed with the CFTC.

NYMEX believes strongly that Congress was correct when it established the CEA's statutory framework to provide for uniform regulation of futures transactions and markets. The Exchange also believes that it is clear that the CFTC currently has and should continue to have exclusive authority and jurisdiction over futures transactions and markets. This is imperative to avoid duplicative and conflicting regulation. To vary from this prudent regulatory structure would only create confusion, inconsistency and uncertainty, ultimately harming the vitality and effectiveness of derivatives markets as well as the broader economy relying upon such markets for price discovery and hedging of risk.

Conclusion

The CFMA is 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 CFMA provides a well-considered oversight framework for futures markets that has enhanced the abilities of NYMEX and the other regulated exchanges to operate in a rapidly changing business environment. The Exchange further believes that the tiered statutory structure for trading facilities has been effective in many respects. However, a series of profound changes have occurred in various OTC markets since the passage of the CFMA, including technological advances in trading, such that the regulated DCM, NYMEX, and the unregulated ECM, IntercontinentalExchange, have become highly linked trading venues. As a result of this phenomenon, which could not have been reasonably predicted only a few short years ago, the current statutory structure no longer works for certain markets now operating as ECMs.

Specifically, the regulatory disparity between the NYMEX and certain ECMs, particularly the ICE, which are functionally equivalent, has created serious challenges for the CFTC and for NYMEX in its capacity as an SRO. NYMEX has also concluded that ECMs such as ICE, which function more like a traditional exchange and which are linked to an established exchange, should be subject to regulation of the CFTC for certain products in the form of large trader reporting, position limits/accountability levels and self-regulatory responsibilities. In addition, the continuing exchange-like aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple implications for other clearing members and for various clearing organizations that share common clearing members. Consequently, legislative change is necessary to address the real public interest concerns created by the current structure of the OTC electronic trading market and the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

Finally, over thirty years ago, Congress unambiguously gave the CFTC exclusive statutory authority over the regulation of futures transactions. This exclusive authority has been reaffirmed by Congress in every subsequent reauthorization of the CEA and is also established case law in the Federal courts. NYMEX believes strongly that the CFTC currently has and should continue to have exclusive authority and jurisdiction over futures transactions and markets. To vary from this prudent structure would only create confusion, inconsistency and uncertainty, ultimately harming the vitality and effectiveness of derivatives markets as well as the broader economy relying upon such markets for price discovery and hedging of risk.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions that any Members of the Committee may have.

Mr. ETHERIDGE. Thank you, sir. Mr. Carlson.

STATEMENT OF LAYNE G. CARLSON, CORPORATE SECRETARY AND TREASURER, MINNEAPOLIS GRAIN EXCHANGE, MINNEAPOLIS, MN

Mr. CARLSON. Good morning. My name is Layne Carlson and I am an officer of the Minneapolis Grain Exchange. It is a great pleasure to be here before the Subcommittee and speak on matters important to us. The Minneapolis Grain Exchange is both a Designated Contract Market for trading futures and a Derivatives Clearing Organization, which means we clear all trades executed on our market and assume all counterparty risk that the buyers and sellers will make payment for the contracts traded. As a Designated Contract Market and a Derivatives Clearing Organization, the MGEX is subject to CFTC oversight of our trading markets and our clearing operations.

The Grain Exchange was first established in 1881 and is the only futures and options market for hard red spring wheat and five index contracts based on wheat, corn and soybeans. Clearly, our current focus on agricultural based contracts and being located in the Midwest these past 126 years, we are part of that bread basket of America. However, traders from around the world now trade our contracts and that trend is expected to continue. Trade volume and open interest records are becoming routine at the Grain Exchange. In short, the Grain Exchange provides a demonstrated and valuable service to the public for price discovery and risk control that goes beyond just agriculture, merchandising and food product sectors.

While the Grain Exchange is not the size of the better known contract markets in Chicago and New York, we can be and are affected by global events, domestic and international policies, Federal laws and CFTC rules and regulations. Events and rules that may affect large markets nominally may be significant to the MGEX, our clearing members, our market participants and our membership. Consequently, what is put into or left out of the bill reauthorizing the CFTC can be positive or detrimental to us as a viable market.

One item that is debated from time to time is folding the CFTC into the Securities and Exchange Commission. From the viewpoint of the Grain Exchange, we believe that would be detrimental. While the CFTC and the SEC share some common goals, such as protecting the marketplace from fraud, we also have unique and competing purposes. No more so was this in evidence than the recent events surround Sentinel Management Group. Sentinel was a specialized firm investing funds on behalf of other firms, many of whom were small clearing members at the Grain Exchange. When Sentinel froze the release of customer funds, it put a severe strain on them and had the potential to materially affect the operations of the Grain Exchange.

The CFTC recognized the risk to the futures industry and worked with the exchanges and the clearinghouse on behalf of the FCMs to get some of those funds released so that certain FCMs could remain a going concern. The SEC, on the other hand, initially tried to prevent the release of the funds. The point being, a Federal regulator that is more closely attuned to the needs of those it is regulating is preferable to a regulator that is monitoring multiple industries.

As mentioned earlier, the MGEX is not the size of our larger contract markets. As such, when laws and rules focus on addressing issues deemed important to them or the futures industry it can have a material and unintended spillover effect to the Grain Exchange. In other words, in this instance, a one-size-fits-all approach regulatory law may not—may be easier to draft and implement, but it often creates unnecessary cost for the Grain Exchange, which is forced to address compliance issues not present in our size market. A perfect example was the perceived conflict of interest within large for-profit entities. At no time did those allegations of problems within the governance or regulatory structure extend to mutual or not-for-profit entities, such as the Grain Exchange.

Nonetheless, the Grain Exchange was required to meet new regulations mandating a minimum percentage of narrowly defined public directors be placed on our Board and even the establishment of a regulatory oversight committee. The regulatory oversight committee has a requirement of at least three public directors, which is puzzling to the Grain Exchange, since we only have three staff members in our regulatory department. Further, finding qualified individuals to serve in that capacity is not easy and it is going to likely require funding. In short the MGEX gets penalized for something perceived happening elsewhere in the industry.

An annual budget topic that won't go away is the transaction fee for commodities trades that are executed. While a source of revenue for the government, it is essentially another layer of taxation on the futures industry. The industry in which we operate is extremely price competitive and worldwide the focus, again, is on reducing costs and fees to be competitive. The MGEX is no different. We have to look at our trading costs, as well. A Federal transaction fee can only hinder our ability to be competitive on cost. Further, the regulatory burden should not be placed just on market participants since all taxpayers benefit from that.

The MGEX is very supportive and thankful for the regulatory changes Congress was able to initiate by passing the CFMA of 2000. We view the Act as a welcome potential to reduce the regulatory burden experienced by traditional and domestic markets, compared to foreign. The MGEX believes there has been an improvement in the area and we would like to thank the CFTC, as well, for moving from a very prescriptive regulatory policy to a more flexible approach with the introduction of core principles. In short, we support the reauthorization of the CFTC.

The MGEX again thanks the Subcommittee for this opportunity to express our views.

[The prepared statement of Mr. Carlson follows:]

PREPARED STATEMENT OF LAYNE G. CARLSON, CORPORATE SECRETARY AND TREASURER, MINNEAPOLIS GRAIN EXCHANGE, MINNEAPOLIS, MN

Good morning, my name is Layne G. Carlson and I am an officer of the Minneapolis Grain Exchange (MGEX). It is a great pleasure to be here before the Subcommittee on General Farm Commodities and Risk Management, and speak on matters important to us.

The Minneapolis Grain Exchange is both a Designated Contract Market (DCM) for trading futures and a Derivatives Clearing Organization (DCO) which means we clear all trades executed on our market and assume the counterparty risk that the buyers and sellers will make payment for the contracts traded. As a DCM and DCO, the MGEX is subject to CFTC oversight of our trading markets and clearing operations.

The Minneapolis Grain Exchange was first established in 1881, and is the only futures and options market for Hard Red Spring Wheat, and five Index contracts based on wheat, corn and soybeans. Clearly, our current focus is on agriculture based contracts. Being located in the Midwest these past 126 years, we are part of the bread basket of America. However, traders from around the world trade our contracts and that trend is expected to continue. Trade volume and open interest records are becoming routine at the MGEX. In short, the MGEX provides a demonstrated and valuable service to the public for price discovery and risk control that goes beyond just the agriculture, merchandising, and food product sectors.

While the MGEX is not the size of the better known contract markets in Chicago and New York, we can be and are affected by global events, domestic and international policies, Federal laws, and CFTC rules and regulations. Events and rules that may affect large markets nominally may be significant to the MGEX, our clearing members, market participants and membership. Consequently, what is put into or left out of any bill reauthorizing the CFTC can be positive or detrimental to the MGEX' future as a viable market.

One item that is debated from time to time, is folding the CFTC into the Securities and Exchange Commission (SEC). From the viewpoint of the MGEX, we believe that would be detrimental. While the CFTC and SEC share some common goals, such as protecting the marketplace from fraud, each also have unique and competing purposes. No more so was this in evidence than with the recent events surrounding Sentinel Management Group, Inc. (Sentinel). Sentinel was a specialized firm investing funds on behalf of other firms, many of whom were small clearing members investing customer funds. Some of these firms were clearing members and futures commission merchants (FCMs) at the MGEX. When Sentinel froze the release of customer funds, it put a severe strain on them and had the potential to materially affect the MGEX. The CFTC recognized the risks to the futures industry and worked with the exchanges and clearing houses on behalf of FCMs to get some of the funds released so that certain FCMs could remain a going concern. The SEC, on the other hand, initially tried to prevent the release of the funds. The point being, a Federal regulator that is more closely attuned to the needs of those it is regulating is preferable to a regulator that is monitoring multiple industries.

As mentioned earlier, the MGEX is not the size of the larger contract markets. As such, when laws and rules focus on addressing issues deemed important to them or the futures industry, it can have a material and unintended spillover effect to the MGEX. In other words, a one-size-fits-all approach to regulatory laws and rules may be easier to draft and implement, but it often creates unnecessary costs for the MGEX which is forced to address compliance issues not present in our size market. A perfect example was the perceived conflicts of interest within the large for profit entities. At no time did the allegations of problems within the governance or regulatory structures extend to the mutual or not for profit entities such as the MGEX. Nonetheless, the MGEX was required to meet the new regulations mandating a minimum percentage of narrowly defined public directors be placed on our board and the establishment of a Regulatory Oversight Committee (ROC). The CFTC requirement that the MGEX create a ROC consisting of at least three public directors to monitor the MGEX regulatory department consisting of three staff employees is entirely puzzling. Further, finding qualified individuals to serve in that capacity is not easy and will likely require funding. In short, the MGEX gets penalized for something perceived happening elsewhere in the industry.

An annual budget topic that won't go away is the transaction fee for each commodities trade executed. While a source of revenue for the government, it essentially is another layer of taxation to the futures industry. The industry in which we operate is extremely price competitive. Worldwide, the focus is on reducing costs and fees to remain competitive. The MGEX is no different; we have to look at our trading and clearing costs as well. A Federal transaction fee can only hinder the ability to be competitive on cost. Further, the regulatory burden should not be placed on just market participants since all taxpayers benefit from government oversight.

The MGEX was supportive of and thankful for the regulatory changes Congress was able to initiate by passing the Commodity Futures Modernization Act of 2000. The MGEX viewed the Act as a welcome potential to reduce the regulatory burden experienced by traditional domestic contract markets compared to foreign markets. The MGEX believes there has been an improvement in that area. The MGEX expresses its thanks to the CFTC as well for moving from a very prescriptive regulatory policy to a more flexible approach with the introduction of core principles. However, the MGEX would like to see Congress' original intention for a flexible regulatory environment extended further to specifically account for small contract markets or not for profit entities. The MGEX looks forward to working with CFTC Acting Chairman Lukken and the other Commissioners in applying that flexibility.

The Act also opened up the domestic market to non-traditional trading markets such as DTEFs and ECMs. These new markets were, for the most part, excluded or exempt from much of the regulatory burdens still imposed on the traditional contract markets such as the MGEX. While the new markets provide many beneficial trading products, the traditional small markets remain under a regulatory oversight that even with the changes noted earlier has not moved far enough from its pre-Act days to account for small contract markets. The MGEX is simply looking for that level playing field so that we can compete in areas such as new trade products.

The MGEX again thanks the Subcommittee for this opportunity to express our views. That concludes my testimony.

Mr. ETHERIDGE. Thank you, sir. Mr. Sprecher.

STATEMENT OF JEFFREY C. SPRECHER, FOUNDER, CHAIRMAN, AND CEO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. SPRECHER. Mr. Chairman and Members, my name is Jeff Sprecher. I am the Chairman and Chief Executive Officer of IntercontinentalExchange, which is also known in the industry as ICE. We very much appreciate the opportunity to appear before you today to discuss our views on the reauthorization. ICE was established in the year 2000 as an over-the-counter energy market and since that time, ICE has grown significantly through both innovation and acquisition. It is now a diversified global marketplace in futures and over-the-counter derivatives across a variety of product classes, including agriculture and energy commodities, foreign exchange and equity indices.

Headquartered in Atlanta, ICE now has offices in New York, Chicago, Houston, London, Singapore, Winnipeg and Calgary. ICE hosts three separate markets on our electronic platform. First, there is ICE's over-the-counter energy market, which operates under the CEA as an exempt commercial market. Second is a British subsidiary, ICE Futures Europe, which was formerly known at the International Petroleum Exchange of London, and that is regulated by the UKFSA. Third is an American subsidiary, ICE Futures U.S., which was formerly known as the New York Board of Trade, which is a Designated Contract Market under the CEA. ICE recently also acquired the Winnipeg Commodity Exchange, a regulated futures exchange in Canada, which will also be migrated to the ICE electronic platform shortly.

ICE Futures U.S. offers both traditional open-outcry trading, as well as electronic trading in futures and options on soft commodities like coffee, sugar and cotton, and financial indices and currencies. ICE Futures U.S. is headquartered in New York City. Adding electronic trading to these markets, beginning just this past February, gave market users greater flexibility in trade execution with availability via the Internet or dedicated lines anywhere in the world. As a result, ICE Futures U.S. became more competitive in the global marketplace, as evidenced by a rapid increase in trading volume in excess of 35 percent. ICE also acquired a U.S. clearinghouse which is now called ICE Clear U.S. and it continues to be operated as a registered Derivatives Clearing Organization under the CEA.

As the Subcommittee considers the reauthorization of the CEA, we urge you to maintain the principles-based regulatory structure and flexibility that is embodied in the landmark Commodity Futures Modernization Act of 2000. In particular, the tiered system of regulation provides regulatory certainty and has placed the United States in a better position to attract business and maintain its competitive position in a global marketplace. ICE and it market participants, including energy producers, distributors and users have benefited significantly from regulatory flexibility that is embodied in the CFMA through the ECM structure established under Section 2(h)(3) of the Act.

At the time of ICE's formation, commercial hedgers had only two options if they wished to hedge energy price risk. They could seek to hedge their risks through one of a limited number of futures contracts that were traded on a regulated exchange, such as NYMEX, which offered liquidity, however, the terms of which were often an imperfect match for the hedging needs of commercial users. Or they could work with an investment bank or so-called voice broker, to negotiate a bilateral swap contract to address their specific hedging needs in a more tailored fashion. The bilateral swap markets were less than transparent and the commercial hedger often had little sense of where the true market was and whether it was being charged a fair price by the dealer or the voice broker.

I formed ICE to bridge the gap between the existing futures market and voice brokered swaps market. Fundamentally, ICE's over-the-counter functionality serves as an electronic voice broker, offering its services to institutional and commercial entities that participate in the over-the-counter markets, but allowing them to trade in a more transparent and much more cost-effective manner. ICE offers some bilateral swaps that are financially settled based on a futures contract price. We also offer a large number of customized swaps that are tailored to delivery locations of users around the country, and thus, are better able to meet the specific hedging needs of the end-user.

Importantly, we offer all of these contracts through a transparent electronic marketplace that does not discriminate between market users, including the small utility, who gets the same treatment as a large investment bank. Furthermore, viewers and users can see the entire bid/offer stack, giving them access to the depth of market and the liquidity in the market. These tangible benefits from ICE's commercial markets include more efficient hedging of price risk, greater transparency in all parts of the market, not just the benchmark futures hubs, and vastly improved liquidity through the introduction of more market participants.

These benefits were brought about by ICE's innovative business model, its product offerings and other changes to markets that were stimulated by our competitive challenge. As markets have grown and developed since the passage of the CFMA, so have new regulatory challenges. ICE advocates a targeted approach to any reform of the CEA, recognizing unique characteristics of many customized markets that have evolved and the importance of continuing to encourage market innovation.

In this regard, some level of additional reporting and a system of position accountability may be appropriate for certain ECM contracts, specifically, those that settle on futures market contract prices and that are the true equivalent of regulated futures. However, most of the energy swap contracts traded on ICE are niche products that are over-the-counter markets, that are illiquid and they are not amenable to the application of such requirements. ICE therefore urges the Subcommittee to stay within the current regulatory framework and allow the CFTC to make adjustments that may be appropriate for particular products.

Mr. Chairman, my complete statement has been submitted for the record and I look forward to answering your questions.

[The prepared statement of Mr. Sprecher follows:]

PREPARED STATEMENT OF JEFFREY C. SPRECHER, FOUNDER, CHAIRMAN, AND CEO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. Chairman, I am Jeff Sprecher, Chairman and Chief Executive Officer of IntercontinentalExchange, Inc., or "ICE." We very much appreciate the opportunity to appear before you today to discuss our views on the reauthorization of the Commodity Exchange Act (the "Act" or "CEA").

ICE was established in 2000 as an over-the-counter (OTC) market. Since that time, ICE has grown significantly, both through its own market growth fostered by ICE's product, technology and trading innovations, as well as by acquisition of other markets to broaden its product offerings.

Today, ICE operates a leading global marketplace in futures and OTC derivatives across a variety of product classes, including agricultural and energy commodities, foreign exchange and equity indexes. Commercial hedgers use our products to manage risk and investors provide necessary liquidity to the markets. Headquartered in Atlanta, ICE has offices in New York, Chicago, Houston, London, Singapore, and Calgary.

ICE hosts three separate markets on our electronic trading platform—ICE's OTC energy market, which operates under the CEA as an "exempt commercial market," or ECM, and two subsidiaries: ICE Futures Europe, formerly known as the "International Petroleum Exchange," which is regulated by the UK Futures and Securities Authority and ICE Futures U.S., formerly known as "The Board of Trade of the City of New York (NYBOT)," which is a regulated Designated Contract Market (DCM) under the CEA.

ICE Futures U.S. offers traditional open-outcry trading in futures and options on soft commodities (coffee, sugar, cocoa, cotton, and orange juice), financial indexes and currencies through trading floors located in New York City and in Dublin, Ireland. In February 2007, ICE Futures U.S. started trading its core agricultural futures on the ICE electronic platform, side-by-side with open outcry and we are in the process of introducing electronic trading of futures and options in our equity index and foreign currency products. Adding the electronic platform gave market users greater flexibility in trade execution, with availability via Internet or dedicated lines anywhere in the world. As a result, ICE Futures U.S. became more competitive in the global marketplace, as evidenced by a 36% increase in volume in soft commodity futures during the first 6 months following initiation of electronic trading, compared to the same 6 month period in 2006.

ICE also acquired NYBOT's clearinghouse, which is now called "ICE Clear U.S." and continues to be operated as a registered Derivatives Clearing Organization (DCO) under the CEA. Currently, it only clears trades transacted on ICE Futures U.S.. ICE's other contracts are cleared through LCH.Clearnet Ltd. in the United Kingdom, but plans are underway to transition ICE's other contracts to our own, newly-formed UK clearinghouse.

As the Subcommittee considers reauthorization of the CEA, we urge you to maintain the principles-based regulatory structure and flexibility embodied in the landmark Commodity Futures Modernization Act of 2000 (CFMA). In particular, the tiered system of regulation provides regulatory certainty and has placed the United States in a better position to attract business and maintain competitiveness in the global marketplace. U.S. futures and derivatives markets flourished, while new technologies and products tailored to meet the changing needs of commercial customers and investors were given the opportunity to develop.

ICE and its market participants, including energy producers, distributors and users, benefited significantly from the regulatory flexibility embodied in the CFMA through the ECM structure established under section 2(h)(3) of the Act. It allowed the development of a transparent electronic trading system for commercial and professional market users, allowing them to hedge risk in a more efficient and effective manner.

As these markets have grown and developed since passage of the CFMA, new regulatory challenges have emerged. ICE advocates a targeted approach to any reform of the CEA. Such an approach recognizes the unique characteristics of the many customized markets that have evolved and the importance of continuing to encourage market innovation.

In this regard, some level of additional reporting and a system of position accountability may be appropriate for certain ECM contracts—specifically, those that settle on a futures market contract price and that are the true economic equivalent of a contract actively traded on a regulated futures market. However, most of the energy swap contracts traded on ICE are niche OTC products that are not amenable to the application of such requirements. ICE therefore urges the Subcommittee to stay within the current regulatory framework and to allow the CFTC to make adjustments that may be appropriate for a few particular products.

Background and History

At the time of CFMA's passage and ICE's formation, commercial hedgers had two primary options if they wished to hedge energy price risk—they could seek to hedge their risk through one of *the limited number of futures contracts traded on an exchange,* such as NYMEX, or they could work with an investment bank or so-called "voice broker" to negotiate a bilateral swap contract to address their hedging needs in a more tailored fashion. Each of these markets had its benefits and drawbacks.

Futures exchanges such as NYMEX offered *a limited number of highly liquid benchmark contracts.* While these pricing benchmarks offered deep liquidity (and hence a better view of true market price at a given location), they usually did not address the precise hedging needs of the commercial user due to the limited number of contracts traded and the limited number of delivery points of those contracts. For example, a NYMEX Henry Hub natural gas futures contract is tied to the price of natural gas delivered at the Henry Hub in Tailgate, Louisiana. While relevant, the price of natural gas at the Henry Hub does not define the price of natural gas at all locations around the country for a large number of reasons, ranging from the influence of transportation and storage costs to local supply and demand dynamics. For this reason, futures contracts did not provide a complete hedge of the commercial user's ultimate price risk. In addition, a physically delivered futures contract had the added problem that if held to expiration (the time through which a commercial user might need to hedge price risk), the holder of the contract could be forced to make or take delivery of the underlying commodity.

Furthermore, NYMEX was, until the introduction of meaningful competition by ICE, overwhelmingly an *open outcry* trading market. The hedger or customer wishing to execute business would call its broker and typically be quoted a wide "bid/ask spread". Customers often did not even get executed in the quoted range due to the time delay inherent in the process and the absence of firm, executable prices resulted in customers paying more to hedge their price risk—making their businesses more expensive to operate, with costs ultimately either being born by the business itself (resulting in lower operating margins) or by its customers (higher prices being charged to customers). Finally, open outcry gave floor traders who were trading *for their own account* an important time and information advantage in the market.

Alternatively, if the hedger sought to hedge its price risk through use of a bilateral swap contract executed with a dealer (such as an investment bank) or through the services of a voice broker, the hedger faced a number of different trade-offs. On the one hand, the hedger could better tailor the product to its specific hedging needs, for example, by entering into a swap contract that was tied to a delivery point closer to where the commodity would be used. On the other hand, bilateral swap markets tended to be opaque and the commercial hedger often had little sense of where the true market was and whether it was being charged a fair premium by the dealer or voice broker for shifting the risk in question. Finally, there was no guarantee of fairness in pricing—different fees and better terms could be charged to different customers—meaning the small commercial player with limited hedging needs might not be offered the same opportunity as another market participant that transacted a significant volume of business with the investment bank or voice broker. As a result, spreads might be even wider than in the futures market.

I formed ICE to bridge the gap between the existing futures market and the voice brokered swaps market. In addition to offering bilateral swaps tied to individual futures contracts (swaps that were financially settled and could be held to contract expiry), ICE also offered a large number of tailored swap contracts that, like those being offered in the broader OTC swaps market, were better tailored to the delivery locations of users around the country and thus better tailored to the specific hedging needs of the end user. Importantly, ICE offered all of these contracts through a transparent electronic marketplace offering firm, executable prices and employing a strict best bid/best offer trading protocol that did not discriminate between market users (the smallest utility would get the same treatment as the largest investment bank). Furthermore, ICE offered users a view into the "bid/offer" stack so that market participants could for the first time assess the depth of liquidity in a market.

In summary, ICE provided market participants a compelling alternative to the hedging opportunities then being offered by the futures market or by the voice-brokered swaps market. Fundamentally, however, ICE served as an "electronic voice broker," offering its services to the same institutional and commercial entities participating in the OTC market, but allowing them to trade in a more efficient and cost effective manner.

Responding to the needs presented by the downturn in the merchant energy markets in 2002, ICE continued to innovate through its subsequent introduction of "cleared" OTC swap contracts. Following its acquisition of ICE Futures Europe (formerly the International Petroleum Exchange), ICE for the first time had the infrastructure to offer the option of credit intermediation in a swap contract to better provide liquidity to the marketplace. The elimination of bilateral counterparty credit risk was an important innovation facilitated by the CFMA, which allowing contracts to be cleared through third party clearing arrangements such as the one ICE entered by ICE with a third party clearing house.

Benefits to the Marketplace

Ultimately, the tangible benefits to the marketplace included more efficient hedging of energy price risk (tighter markets), greater price transparency in all parts of the marketplace (not just at benchmark hubs tied to futures contracts), and vastly improved liquidity through the introduction of more participants (and thus greater price competition) in the markets. These benefits have not been limited to those brought about directly by ICE's business and its product offerings, but include those resulting from changes to the business models and product offerings of other market participants that responded to the competitive challenge presented by ICE's business. It is ultimately for others to determine cause and effect, but one cannot ignore the question of whether and how quickly other parts of the market, in some cases dominated by member interests, would have adopted electronic trading and pursued product innovation in the absence of the competition presented by ICE's markets.

One Size of Regulation Does Not Fit All Markets or Contracts

As these markets have grown and developed, new regulatory challenges have emerged, requiring a thorough and careful review by Congress and the CFTC during the CEA reauthorization process. As we have stated previously before this Subcommittee, ICE advocates a targeted approach to any reform of the CEA. This approach recognizes the unique characteristics of the many customized markets that have evolved under the CFMA. Unfortunately, some in Congress are suggesting a uniform approach to regulating these markets. This would be a great mistake.

The problem with "one-size-fits-all" regulation can best be illustrated by contrasting the historic nature of futures markets (limited number of actively traded benchmark contracts, all transactions executed through a broker who can trade for its own account or that of a retail customer) with the ECM OTC swaps markets (large number of niche products, many illiquid and thinly traded, principals only trading). Recognizing the importance of futures pricing benchmarks to the general public (a DCM is obligated to publish its prices to be used by the broader market), and in recognition of the potential for conflicts of interest due to members trading for their own accounts alongside business transacted on behalf of customers, some of whom were retail customers, DCM core principles were developed to facilitate regulation of the markets by the DCM, which acted as a self regulatory organization. The typical high level of liquidity in benchmark contracts make application of core principles such as market monitoring and position accountability and limits feasible and appropriate.

Suggesting that these same DCM core principles, which were developed with the futures exchange model in mind, should apply to all OTC swap contracts traded on an ECM market is attempting to fit the proverbial square peg in a round hole. While some level of additional reporting and a system of position accountability may be appropriate for certain contracts—specifically, *those that settle on a futures market contract price and that are the true economic equivalent of a contract actively traded on a regulated futures market—most of the energy swap contracts traded on ICE are niche OTC products* that trade in *illiquid markets* that are not amenable to the application of DCM core principles. For example, how would an ECM actively monitor an illiquid swaps market in an attempt to "prevent manipulation" where price changes can be abrupt due to the limited liquidity in the market? How would an ECM swaps market administer accountability limits in a market that has only a handful of market participants? Should the ECM question when a single market participant holds 50% of the liquidity in an illiquid market when the market participant is one of the few providers of liquidity in the market?

It is important to analyze these questions not in isolation, but in the context of market participants having alternatives such as OTC voice brokers through which they can conduct their business. Importantly, such OTC voice brokers can even offer their customers the benefits of clearing through use of block clearing facilities offered by NYMEX (and also by ICE). Faced with constant inquiries or regular reporting by the ECM related to legitimate market activity, and facing no such monitoring when it transacts through a voice broker, market participants might choose to conduct their business elsewhere. It is for these and other reasons that Congress and the Commission have developed the carefully calibrated two-tier regulatory structure applicable to DCMs and ECMs. We believe that the judgments made by Congress and the Commission thus far have been prudent and should generally be maintained.

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive markets in energy commodities and other derivatives, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly-held company, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with the CFTC and other regulatory agencies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets. We have also worked closely with Congress to address the regulatory challenges presented by emerging markets and will continue to work cooperatively for solutions that promote the best marketplace possible.

However, in prescribing regulation, it is important to consider the fundamental nature of the market in question and avoid engaging in a superficial, "one-size-fits-all" analysis that would unduly burden the efficient operation of markets and potentially stifle innovation. In short, the level of regulation should fit the market in question both in terms of the users who can access the market as well as the amenability of the market to active monitoring and the prevention of manipulative activity.

The goal of regulation fitting the characteristics of the market in question has been ably achieved under the principles-based regulation embodied in the CFMA, and calls to apply DCM core principles to illiquid markets, to replace the ECM category of marketplace with a more regimented level of oversight, or to eliminate the ECM category entirely, are misguided and counterproductive. The CFMA has allowed for greater competition and heightened transparency and provided the CFTC with a deeper view of the OTC markets than they would have otherwise had.

Mr. Chairman, thank you for the opportunity to share our views with you on reauthorization of the CEA. We look forward to continuing to work with the Subcommittee and your staff as you address this critical reauthorization. I would be happy to answer any questions you may have.

Mr. ETHERIDGE. Thank you, sir. Dr. Walsh.

STATEMENT OF MICHAEL J. WALSH, PH.D., EXECUTIVE VICE PRESIDENT, CHICAGO CLIMATE EXCHANGE, CHICAGO, IL

Dr. WALSH. Good morning, Mr. Chairman and Committee Members. Thank you for the chance to be here. I am a last minute substitute for Dr. Richard Sander, who, under doctor's orders was told to stay in bed for a day or two and I appreciate the opportunity to brief you. The Chicago Climate Exchange is a real life example how the vision that under-lied the establishment of the Exempt Commercial Market structure has led to significant economic and social benefits for American businesses and farmers and foresters, because we were able to build an exchange rapidly and in an environment that fostered innovation and led to these benefits.

The Chicago Climate Exchange operates a voluntary but legally binding greenhouse gas emission reduction and trading program. As you know, there is no such regulatory requirement for management of greenhouse gases in North America at this time, but many American businesses and businesses throughout the Western Hemisphere wanted to prepare and build their abilities to operate under market-based carbon constraints they are facing internationally. And more importantly, the Chicago Climate Exchange wanted to demonstrate firmly how U.S. farmers and foresters can be a core part of the solution set in market-based mechanisms to reduce greenhouse gas emissions and global warming.

The Commodity Futures Modernization Act and its Exempt Commercial Market structure were critical in facilitating the implementation of Chicago Climate Exchange. It fostered innovation, speed to market and allowed us to be competitive on a global basis, as I will briefly explain in a moment. Chicago Climate Exchange also made the very important decision to develop a self-regulatory structure. We did this by establishing a detailed rule book for the cap-and-trade mechanism that governed the environmental aspects of the program, providing a transparent market, and by contracting with the NASD, now known as the Financial Industry Regulatory Authority, or FINRA, to provide regulatory services.

Now, this is a market mechanism for environmental improvement that is modeled on the law that the U.S. Congress passed in 1990, establishing a sulfur dioxide reduction cap and trade program. The members of the Exchange execute a legally binding contract to annually reduce their greenhouse gas emissions, have them independently audited—and every member of the Exchange has its emissions independently audited. All of the mitigation projects, such as agricultural soils, methane capture, reforestation, such as Senator Lucas' farm, are subject to independent verification by qualified experts.

So in achieving the annual emission reduction goals, there are options, there is flexibility. The members can either internally reduce their emissions or they can partner with other members of the Exchange, such as those industrial or governmental enterprises that beat the emission reduction goal and they can make a trade so they can combine to achieve the goals, or they can partner with the U.S. farmers and foresters who do qualified and verified mitigation practices on farms, livestock operations and forests. It has become a significant enterprise and there is lots of learning going on, lots of business opportunity being developed.

The members of the Exchange, almost 350 members now, include agricultural businesses such Cargill and Smithfield Foods, Ford Motor Company, Temple Inland, Waste Management, Dupont, Bayer, universities, Bank of America. We have got a couple of states, several cities, even the United States House of Representatives has decided that it wants to, in part, address its greenhouse gas mitigation through participation in the Exchange. We are very happy to see engagement and participation around the world. It is critical to engage our partners in building these solutions wherever we can, including China and India.

Now, it turns out that the members of the Exchange have found amazing internal efficiencies, business opportunities in developing new renewable energy and energy management systems, and they have a price of carbon to work towards and to manage towards. Many of the members joined the Exchange for lots of reasons, to better manage their emissions and energy consumption, but we would not have been able to establish this mechanism, this organized rules-based self-regulatory structure without the ECM structure, without the rule that facilitates and fosters innovation.

Let me spend a short moment—I would love to spend a lot more time on this, my favorite topic, of how farmers and foresters are finding new income opportunities around the country in providing a global environmental service. The Iowa Farm Bureau, the North Dakota Farmers Union, farmers and foresters throughout the country are doing greenhouse gas mitigation services and being paid for it, right now. We would not be here if we were not able to expeditiously build the start-up mechanism and get it going. I should note that the Chicago Climate Exchange has been able to implement, in the field, some of these agricultural and forestry practices and verify those under a grant from the USDA, full disclosure.

So we are demonstrating, on a daily basis, a globally significant piece of progress for environmental improvement and a cost-efficient rules-based structure. Had we faced a significantly higher cost structure due to institutional regulatory requirements, we would not have been able to get off the ground. It is as simple as that. We do think that having a self-regulatory service, having transparent rules-based markets, is absolutely critical to making sure that the environmental commodity is being exchanged in an area of integrity, but we are seeing, right now, that U.S. businesses, governments, educational institutions, farmers and foresters are enjoying benefits from the ability to quickly implement an innovative new structure.

We would not have been able to realize the significant progress, demonstrating how to do this on the ground, demonstrating the full role that farmers and foresters should be able to participate in a market-based solution had we not been able to operate quickly and under the low-cost structure that the Exempt Commercial Market structure provided. We think it is an important opportunity to foster innovation. We have exported some of our skills sets internationally and now globally and we think this is a very critical innovation fostering element of the CFMA and we look forward to the open discussion. Thank you, Mr. Chairman.

[The prepared statement of Dr. Walsh follows:]

PREPARED STATEMENT OF MICHAEL J. WALSH, PH.D., EXECUTIVE VICE PRESIDENT, CHICAGO CLIMATE EXCHANGE, CHICAGO, IL

Chairman Etheridge, Congressman Moran and Members of the Subcommittee. I want to thank you for your invitation to be with you today. In the context of the discussions regarding Section 2(h)3 of the Commodity Exchange Act, I would like to share with the Subcommittee the experience of developing, launching and implementing the Chicago Climate Exchange ("CCX"), which is a cap-and-trade system that has been trading emissions allowances derived from real emissions reductions and offset projects in the United States since 2003, and the context in which it was created.

As you know, the United States does not require emissions reductions of greenhouse gases and therefore most elements of the U.S. economy have not been able to access what has become known as the "carbon market." However, the successful innovation, design and operation of CCX has enabled key members of the U.S. economy, including the agriculture sector, to realize the significant economic, financial, social and operational benefits associated with the reduction of greenhouse gas emissions and emissions trading, which was pioneered in the United States as part of the Clean Air Act.

The Commodity Futures Modernization Act ("CFMA") and the implementation of the Exempt Commercial Market ("ECM") status were critical to facilitating the creation of the Chicago Climate Exchange. The intentions of the CFMA in terms of enabling legislation to foster innovation, "speed to market" and to enhance the competitiveness of U.S. commodities markets were fundamental in the development of CCX. At the same time, CCX's decision to develop a self-regulatory structure was fundamental in ensuring the credibility and integrity of this nascent market. CCX did this by developing a rulebook for its cap-and-trade system, providing a transparent market and by contracting with the NASD, now FINRA, to provide regulatory services to CCX.

CCX is a financial institution that exists to advance economic, environmental and social goals. We are the world's first, and North America's only, voluntary but legally binding rules-based greenhouse gas emission reduction and trading program, as well as the only global emissions trading system handling all six greenhouse gases with a multi-sector emissions reduction requirement. Designed in 1999 and 2000 as a pilot project based in the Midwest, CCX began trading in 2003, and its membership has grown to almost 350 diverse entities including some of the most significant names in the American economy.

Emissions of CCX Members represent 14% of stationary emission sources in the United States. CCX members execute legally binding commitments to meet annual emission reduction goals of 4% below baseline for 2006 and 6% below by 2010, at a minimum. Members who exceed their reduction commitments may sell allowances; those who do not make the required cuts must buy allowances to come into compliance. CCX Rules require that all emission baselines, annual reduction commitments and offset projects are subject to a standardized third party verification by FINRA. As an ECM, screen trading is principal-to-principal trading. FINRA conducts market surveillance to monitor trading activity on the CCX trading platform for market manipulation and fraud.

CCX Membership includes representatives from a diverse array of economic sectors, both domestically and abroad, including nearly every state represented on this Committee. Among these sectors, CCX membership includes agricultural entities (Cargill and Smithfield Foods), automotive (Ford Motor Co.), utilities (American Electric Power and American Municipal Power), chemicals (DuPont, Bayer and Dow Corning), forestry (International Paper and MeadWestvaco), academic institutions (Michigan State, Iowa, Minnesota and Oklahoma) and financial institutions (Bank of America), and public sector entities such as the States of New Mexico and Illinois, seven municipalities and three counties (King County, County of Sacramento and Miami-Dade County). Approximately 25 million people live and work in the cities, counties and states which are members of CCX and another 2 million are employed by its corporate members. In addition, I am proud to note that the U.S. House of Representatives itself is in the process of becoming an Exchange Participant on the Chicago Climate Exchange as part of its efforts to address the greenhouse gases derived from operating this building and its offices.

CCX international membership includes a city and a utility in Australia (Melbourne and AGL), and eight companies in South America which have taken on a legally-binding commitment to reduce their emissions even though they are not yet required to do so. We have also engaged the interest of both Chinese and Indian policy leaders on the issue of market-based initiatives to address environmental concerns. We have approved and registered offset projects from both China and India, as well as Costa Rica and Brazil.

Members report that the baselines, audits and annual commitments represent concrete goals that help them focus on internal efficiencies and attendant financial opportunities. They reduced their emissions through increased energy efficiency, expanded use of renewable fuels, and realized low-cost reductions in non-CO_2 greenhouse gases through use of direct abatement equipment. Many members have exceeded their reduction targets. As an important aside, another benefit of the price discovery mechanism provided by an organized market is the ability to spur innovations. Now that the price of carbon is more transparent, entrepreneurs in areas related to clean energy have been able to raise capital from both fixed income and equity investors after factoring in CCX prices in their business plans.

Members join CCX for various reasons, but all for at least these reasons: to better master their emissions data and to gain early adopter benefits with price discovery for carbon and all aspects of risk mitigation, including financial, operational, and reputational. To date, CCX Members as a group have reduced their emissions by almost 11% beyond their annual commitments, representing 90 million tons of reduction of CO_2 in the first three compliance years. These activities have placed CCX members in the United States at the forefront of a major economic opportunity. Had CCX not been able to form as an ECM, these benefits would have been lost, along with the vital time needed to build our infrastructure in order to address these important environmental and economic challenges.

In addition, the CCX Offsets Program is proving successful at rewarding emissions mitigation through sustainable farming and forestry, while also providing a new income source for U.S. agriculture. Entities such as the Iowa Farm Bureau and the National Farmers Union are leading the way in building the infrastructure for the agricultural offsets program. To date, projects representing more than 2 million acres of conservation tillage and grassland in multiple U.S. States have been registered, verified and sold through the Exchange. In 2005 and 2006, over 1.2 million acres in the U.S. have been enrolled, with producers earning over $3 million from the sale of CCX Carbon Financial Instrument contracts. The same growth was experienced in the tonnage enrolled under the agricultural methane program, which went from 24,100 tons to 207,200 tons during the same period. These offsets provide a least-cost avenue for society to reduce greenhouse gas emissions in addition to enhancing farm profitability and income diversification.

American agricultural producers are taking a leadership role in promoting long term sustainability of U.S. agricultural soils through the CCX. The CCX Offsets Committee has recently approved protocols for rangeland management soil carbon offsets projects, which will soon be registered in the Exchange. A Member of this Congress, Senator Richard Lugar, has registered reforestation credits from trees planted at his Indiana family farm, which is helping set the example for many other farmers. CCX is also pleased to inform the Committee that it is received a grant supported by the U.S. Department of Agriculture to further the goals and objectives of the CCX agricultural offset program. Expansion of this program can help minimize the need for additional subsidies, lower the tax burden required to finance them while encouraging behavioral change and innovative practices. It is also important to note that the potential for offsets coming from coal mine/coal bed methane is substantial, and protocols have been approved and projects will soon be registered.

CCX has also created a futures exchange for trading futures contracts based on U.S. SO_2 and NO_X emission allowances—the Chicago Climate Futures Exchange—which is a designated contract market regulated by the Commodity Futures Trading Commission; and the European Climate Exchange, the leading marketplace for carbon emissions in Europe, regulated by the United Kingdom's Financial Services Authority. In a note of irony, we have American ingenuity and financial know-how being exported to Europe. Jobs are being created and an entire new field of specialization is being developed in both the U.S. and around the world. These financial institutions advance social objectives and economically efficient environmental protection by providing rules-based markets with low transaction costs and transparent prices.

The effectiveness of a cap-and-trade system with the above design features is now being demonstrated every day by CCX members across the globe. The environmental and economic benefits being generated are of national and global significance. The innovative approach taken by CCX benefited greatly from its ability to establish and function as an Exempt Commercial Market. The costs of establishing an exchange such as ours from an institutional and regulatory standpoint would have been prohibitive had we not had this opportunity. At the same time, the importance of the regulatory services provided by FINRA in the case of CCX is critical. In a cap-and-trade system the ability to ascertain the quality of the commodity being traded is fundamental for market participants and the integrity of the program.

As you can see from our experience, CCX's objective is to provide a social benefit through the reduction of greenhouse gases in the atmosphere. For that to have happened, proper measurement, monitoring and verification were necessary and, in our case, has enabled thousands of U.S. farmers and foresters to provide an environmental service in a credible and transparent way. We are happy to announce that the world's largest market in terms of emissions under management now operates out of Chicago, and its birth and ability to stay competitive have benefited tremendously from the provisions of the CFMA and the Exempt Commercial Market category.

We hope that our experience in CCX can help inform this important discussion. Thank you again for your interest.

Mr. ETHERIDGE. Thank you, Dr. Walsh. Just so that everyone will know, it looks like we are going to have a vote call somewhere between maybe 11:20 and 11:45, so probably within the next hour. And we will ask each Member, to the extent possible, to constrain yourself to the 5 minutes that will be allocated. The chair will now recognize himself for 5 minutes and I will try to restrain myself within the 5 minute time limit.

Dr. Newsome and Mr. Sprecher, both of you appear to be circling around the same idea that some heightened oversight might be necessary for certain products listed on the ECM. You may differ on the amount and scope of oversight and regulation, you may differ on whether a change in law is necessary to achieve greater oversight, but in principle, you don't seem to be quite that far apart. My question is what is the trigger?

If Congress is to act in this area, we could write a change application just to the contract or the commodity in question, but this would fail to address the next problem that might come along. We could give the CFTC some broader authority, but that might just stifle the innovation. What, in the EMC, should trigger greater oversight? Both of you have touched upon it, to some extent, so please expand upon your own comments on each other's ideas of what should trigger oversight of the EMC traded contract. Whichever wants to begin first.

Dr. NEWSOME. Thank you, Mr. Chairman. I think we have got a real live example to use and we don't just have to talk in theory about what an appropriate trigger might be, and that goes back to the situation with Amaranth and the collapse. This Subcommittee held a hearing about that earlier in the summer, and we talked through it in detail. But I think, in looking back at that situation, there are a couple of things that strike us in terms of the linkage of the ECM contract and natural gas directly to the regulated futures contract. The fact that the ECM natural gas contract served as an effective substitute for the exchange contract and even based upon the CFTC staff comments last week that, in fact, that contract served a price discovery role on a certain percentage of the days that the trading community used it.

So we think those are the key components that can be used as a trigger to create more effective oversight from the CFTC in terms of submission of the large trader reports, position accountability and the self-regulatory oversight functions. We have talked about that contract specifically, but we also believe that other contracts may develop in the same manner as natural gas and that the CFTC should have flexibility to continue to evaluate other contracts and if other contracts, in fact, meet those same triggers that natural gas has met, then that oversight would be accepted, as well.

Mr. ETHERIDGE. Thank you, sir. Mr. Sprecher, anything you want to add to that?

Mr. SPRECHER. No, I think he framed the question, actually, quite eloquently, which is we are definitely in broad agreement and there are some nuance differences Dr. Newsome and I have. Generally speaking, when a contract that is less regulated or unregulated becomes the functional equivalent of a regulated contract, it only makes sense that we should close that gap. I mean, we shouldn't create a regulatory arbitrage opportunity within our country.

So the question is how do we do that? I am cognizant that the CFTC has testified here, that they believe they have what they need to handle that and but also, I believe it was at the last hearing on natural gas that Acting Chairman Lukken said he may be at the outer limits of his view on that and so to the extent that the CFTC needs to define that outer limit, needs to push the outer limit a little further, we would certainly support some modification. But generally speaking, I believe that they have the authority and we continue, at ICE, to work with the CFTC to provide more information, more systems, more visibility to help them bridge that gap between ICE and NYMEX.

Mr. ETHERIDGE. Thank you. Let me quickly try to get one other. Mr. Duffy, Dr. Newsome, in each of your written statements, you mention the jurisdictional conflict between FERC and CFTC. Both of you fear FERC's potential encroachment upon the CFTC's exclusive jurisdiction over futures markets. Can either of you give the Subcommittee some practical, real world implications of what could happen to your exchanges and the people who use them if FERC's action does constitute an encroachment in the CFTC's jurisdiction, because some might say, as a question, why shouldn't we have another cop on the beat and what can you tell them?

Dr. NEWSOME. Mr. Chairman, we view this as a very serious issue and one that could go to the core of tearing down the very structure of the Commodity Exchange Act and the jurisdiction of the CFTC. I think FERC is but the example that is in front of us today. If that is allowed to happen, then you are looking at USDA coming in on other contracts, the Treasury on financial contracts and I think the exclusive jurisdiction of the CFTC is what sets us apart from other jurisdictions from around the globe that have allowed the growth and effectiveness of our markets.

We have a specific example regarding FERC and the CFTC with FERC coming in, requesting—probably requesting is not quite strong enough, but almost demanding that we make changes to certain settlements that the CFTC had long approved and was comfortable with and as the Exchange, we are caught in the middle between the views of two Federal regulatory agencies and that is not useful to our market.

Mr. ETHERIDGE. Thank you.

Mr. DUFFY. You know, Mr. Chairman, it would be—I am not even going to try to add to that because I think Dr. Newsome summed it up quite well on all products.

Mr. ETHERIDGE. Thank you, sir. Before we move to my good friend, Mr. Moran, we have been joined by the Chairman of the full Committee, Mr. Peterson. With that, I will move to Mr. Moran and recognize him for 5 minutes.

Mr. MORAN. Mr. Chairman, thank you very much. I am anxious for the day in which the gentleman from Virginia's portrait is hanging in this room. My failure to attend the reception last night is—perhaps you didn't even notice I wasn't there, but now that——

Mr. ETHERIDGE. Now that you have since raised the issue, it is a serious issue.

Mr. MORAN. And as a result of feeling badly about my absence, I would yield my time to the gentleman from Virginia.

Mr. GOODLATTE. Well, the cat is out of the bag now. I thank the gentleman. That day is well nigh and I thank him for his gracious—I want to join the Chairman in expressing my concern about the question of the exclusive jurisdiction of the CFTC over futures contracts. I have had many discussions with a number of you over time about this issue and the various ramifications of it, but I just want to be on the record as saying that I think that if that jurisdiction were to somehow be narrowed, the consequences for your industry and playing in a different arena, if you will, would be significant in the conflict between these two different Federal regulatory agencies. It is not going to be well for the openness and transparency of these markets that I think the CFTC has done a generally good job of protecting.

Let me ask you, in following up on that, if you might just comment on some of the operations of the CFTC. Do you think it is adequately funded? I will start with Mr. Duffy.

Mr. DUFFY. Well, I think the funding would be a budget of around $87 million to $93 million over the last couple years and they were asking for $120 million annually. One of the things that I said in my testimony, a big part of the CFTC's budget goes to chasing off-exchange unregulated platforms and there are hundreds of millions of dollars being lost by people that are soliciting retail people to trade foreign exchange products, promising them great returns that are just literally impossible and we all know it, so the CFTC is chasing these folks. Unfortunately, the way the statute reads, they are chasing them after the crime has been committed, so that is very difficult.

So that is another reason why we need a fix for this retail FX platform, so again, we are very supportive of the Commission getting all the resources it needs. I think I echo your comments, Congressman, that you know, we need to have this single regulator. We do compete globally and for us to have multiple regulators in the U.S., it would cripple us in a global marketplace and again, that is where we do compete. We don't compete so much centrically, we compete globally and again, that is another thing I cited in my testimony that is a problem with the securities industry and why I think that it has been crippled, and IPOs are going to foreign lands *versus* staying here in the U.S., so that would be my view on the funding of the CFTC.

Mr. GOODLATTE. Dr. Newsome.

Dr. NEWSOME. Mr. Goodlatte, I admit up front that I may be somewhat biased as a former Chairman of that agency in my response, but I do believe that the CFTC is under-funded. They have got the lowest level of staff in over 20 years at a time when they are regulating more markets, more contracts. We all know and are aware of the explosion in growth of this business, so I think I would agree with my friend, Mr. Duffy, that we are asking them to do something in a much larger space that has become very, very difficult for them to do. In addition to increasing the funding and staff size, I also think we should increase the penalties in which they have the authority to place upon these wrongdoers that Mr. Duffy mentioned. I think if we increase the penalties as we were all in agreement in reauthorization hearings last year, that, too, would help with some of the jurisdictional issues and penalties that other agencies have.

Mr. GOODLATTE. Let me ask, has it been your experience that the Presidential Working Group responds quickly to matters put before it?

Dr. NEWSOME. In my experience, yes. The PWG has responded very quickly, particularly in issues not only that are significant to the industry, but the Congress is attempting to address, as well.

Mr. GOODLATTE. Mr. Carlson, do you have a view on that?

Mr. CARLSON. We very much have kept up with the Presidential Working Group and we appreciate the work that they have done. Stepping back to the budget size of the CFTC, we believe, from a small exchange standpoint, we have been adequately regulated, so the effect that we see on their budget is nominal, in some respects, but we also notice that they are also chasing off-exchange regulatory matters.

Mr. GOODLATTE. Thank you. And Mr. Duffy, you commented about our ability to remain competitive in the international marketplace and I wonder if you could compare our regulatory regime with that of the Europeans?

Mr. DUFFY. Well, I mean, Jim might be better suited for this question, since he was a big part of the regulatory regime as it was being harmonized throughout the country, especially in Europe, when he was Chairman of the CFTC, but right now, it appears that we are on much more of a level playing field, especially dealing with the European countries, by having our products in there. The CME Group now is in 83 countries throughout the world with our product and we are executing business globally, so as far as the regulatory regime goes, I mean, I think it suits us quite well right now.

Mr. GOODLATTE. Thank you. And that was a handoff to Dr. Newsome, so——

Dr. NEWSOME. I think we have made a lot of progress in leveling the playing field globally. Still, there are some differences that exist. If you look at the Financial Services Authority in the UK recognized as a comparable regulator to the CFTC within the derivatives space, but I think there are some real differences, as well. They have roughly 20 to 30 people that are dedicated solely to the derivatives space, where the CFTC has over 400. If you look at the number of enforcement cases that have been brought by the CFTC, which I think their record is very, very good and aggressive in policing wrongdoing, much, much fewer cases are brought within the European community.

Mr. GOODLATTE. Thank you. Mr. Chairman, I know my time has expired. I wonder if I might direct one question to Dr. Walsh, because I am interested in this new area.

Mr. ETHERIDGE. Proceed.

Mr. GOODLATTE. Can you tell us a little bit about how you determine what various agricultural activities are—is there a schedule, for example, in terms of evaluating that for carbon sequestration?

Dr. WALSH. Yes, Congressman. We have got a variety of tools that have been developed with, really, some of the top experts in the world on these issues from Kansas State University, Virginia

Tech, Ohio State and so on. We have established a schedule of standardized crediting for certain conservation tillage practices when done on a continuous basis, depending on the part of the country that you are located in, which is the function of crop growth, soil types and so forth in the area of methane capture.

There are standard measurement methodologies that have been developed, a little bit of trial and error there, but an important mitigation and clean energy source in the area of rangeland management, we are currently piloting some field tests to confirm our ability to quantify acreage and apply the standard factors on a per acre, per year crediting basis. And in the space of forestation, we use some of the direct measurement and standardized lookup tables that have been established by the Forest Service.

Mr. GOODLATTE. I recognize that we don't have these requirements to reduce greenhouse gases in the U.S. at this time. In light of that, in light of what is going on elsewhere in the world, what is your volume of business and who are your competitors?

Dr. WALSH. Well, Congressman, we operate three separate exchanges. One is an Exempt Commercial Market, which, of course, involves screen trading on a principle-to-principle basis and the trading in that market, spot market trading, is monitored for market manipulation and fraud by FNRA. The volumes in our North America based market are approximately 1⁄100 of the volumes in our European market we established and we sort of exported an American financial know-how and established the European Climate Exchange. We are transacting in the range of about $100 million a day at our London operation. We transact a half a million to a million dollars a day in our U.S. operation.

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

Mr. ETHERIDGE. Thank you, sir. The gentlelady from Kansas, Mrs. Boyda.

Mrs. BOYDA. Thank you, Mr. Chairman. Dr. Walsh, I would just like to say thank you for what you are doing and the work that is going on in Kansas. It is growing. I think we are looking at what is going on around some of our neighboring states and so there is growing appreciation of what you have been trying to do.

Mr. Duffy, if I could—I am new to this. I am one of the new kids in Congress and your initial testimony kind of did this. You seem to be concerned about something and I am not quite sure and if you could just step back and help me understand what your concern was and as it went down the line. I just couldn't figure out where that concern, as such, was coming from.

Mr. DUFFY. The concern is a couple different things, Congresswoman, and the first was on the elimination of 2(h)(3). They have had a bit of a debate about it here.

Mrs. BOYDA. Help me with what 2(h)(3) is.

Mr. DUFFY. 2(h)(3) is the exempt commodity code of the 2000 Act and it gives people an opportunity to trade principle-to-principle with exempt products, so basically, not being regulated and our concern is that some of these products are being competitively traded on an exchange. And Dr. Newsome could talk to this more because he lists these contracts at the NYMEX. We do process them at the CME, because we are their electronic provider for all NYMEX's products, so we are trading these on a regulated platform and they are competed with an unregulated platform, so there are position limits that the CFTC has on a regulated exchange, where on an unregulated platform, they don't have these limits, so there can be manipulation in products.

That concerns us. There is reputational harm if there is manipulation in energy or any other product that harms the entire industry. So even thought the CME doesn't list, as its core products, energy, we do it for the NYMEX. It is still reputational risk to the industry and that concerns us, so again, that is why we believe 2(h)(3) should be eliminated, because there are competing products being traded on regulated platforms that are identical. Second, on our——

Mrs. BOYDA. And again, who would that impact the most here? If it was eliminated?

Mr. DUFFY. I don't know if it would impact anybody, because we have, in my testimony, said that we believe that there is a DTEF solution, which is a Derivatives Transaction Execution Facility, and this has standards that they would have to adhere to, nine core standards which are fairly benign standards, including daily publication of trading information, fitness standards, conflicts of interest, recordkeeping and antitrust consideration, so most exchanges today, the IntercontinentalExchange operates a futures exchange. They already have an SRO.

The Climate Exchange has a futures exchange, as Dr. Walsh has cited, so they already fit under this. We don't believe that innovation would be harmed any way. We, at the CME Group, have been around for 150 years as a regulated institution and we have been able to innovate through that entire time without any problems, so we don't see where there has been any arguments being made that innovation would be stymied, for lack of a better term, so again, we don't see how this impacts anybody if it was to go into a DTEF.

Mrs. BOYDA. Is there agreement or disagreement?

Dr. NEWSOME. From the New York Mercantile Exchange, of course, we operate as a regulated marketplace, just as our colleagues in Chicago. I think the most important concept is the fact that we are in complete agreement with our friends in Chicago that something needs to be done. We are taking a slightly different approach on how you address that.

The CME Group is recommending to repeal the 2(h)(3) and I think it makes some valid arguments. Our approach has been based upon the situation with Amaranth, to take a more targeted approach and address specifically the contracts that are linked to an exchange contract, that serve as an effective substitute, while maintaining the structure of the CFMA as it has been since 2000.

Mr. SPRECHER. We operate both, as Chairman Duffy mentioned, we operate both regulated futures exchanges and Exempt Commercial Markets. I started ICE as the founder, as an Exempt Commercial Market. In other words, I was able to just find two people that were willing to trade with each other across a relatively crude network and from that, build a company. The same thing has happened with Dr. Sander, who started the Chicago Climate Exchange, which we operate for him under an outsourcing relationship, did the same thing.

So the innovation that we are talking about is the ability of entrepreneurs to come in and create new market structures at low cost and to start a self-regulated futures exchange from scratch would be a daunting task. I am not sure it can really be done. And certainly, I couldn't have done it, I will say that. So where Dr. Newsome and Chairman Duffy and I do agree is that at times, if a contract becomes the functional equivalent of a future and has a different regulatory regime, we should take away that regulatory arbitrage.

Nobody is looking to, nobody that I have heard on this panel is looking to take regulated futures into an unregulated environment. That, I don't think, is actually helpful for a market, but to allow entrepreneurs to start new markets at low barriers to entry, which they can do in every other country, I would remind you, I don't think we should preclude that in this country.

Mrs. BOYDA. All right. Thank you very much. Yes?

Dr. WALSH. Congresswoman, first thank you for your kind remarks. We are working hard to grow opportunities in Kansas, in these emerging markets. I would note that it is not just the cost of activating the exchange that would become prohibitive if the designated contract market rules were applied to a lot of these innovative upstarts, not just CCX, but others that are emerging with some promising new opportunities for American businesses, but the cost of participation. Many of the members of Chicago Climate Exchange, take the City of Melbourne, Australia, the University of Minnesota, other governments and small businesses, are not necessarily involved in the Chicago Climate Exchange because they are eager to do so much trading.

They want to learn how to manage their energy and emissions flow, they want to understand the policy implications. They want to prepare for a carbon constrained future. So if we put up the sorts of hurdles that the entities would have to face under a DCM and under a futures market regulatory structure, we might not only kill off the sort of the potential golden goose of the exchange itself, but kill off the possibility for lots of businesses and farmers and foresters to learn how to work in these markets. So it is the exchange and the participation that would become more difficult and costly if we ditch this really innovative provision to foster new market mechanisms.

Mr. ETHERIDGE. Thank you very much. Thank you very much. The gentleman from Texas is recognized for 5 minutes. Just so you know, a vote has been called. This will probably be the last question we are able to get in before we have to take a break. Probably we will be gone anywhere from 15 to 20 minutes and then we will come back and continue. It is two votes.

Mr. CONAWAY. Thank you, Mr. Chairman. Dr. Walsh, a couple of things. What are those hurdles that you say this would put in place that would prevent participants like Melbourne, Australia? Give us a sense of what that hurdle is.

Dr. WALSH. Well, anybody who wants to trade in a futures market has a significant set of procedures to go through to demonstrate wherewithal, to demonstrate understanding and familiarity and these are steps that are absolutely appropriate for the large, economically important commodity futures and financial futures markets, but is this at all necessary? And I think the wisdom of the Congress, in establishing the Exempt Commercial Market structure, said no, that is not necessary, a costly regulatory and reporting set of procedures for these new upstart markets that are indeed, not even a futures market, in our case. This is a spot market.

Mr. CONAWAY. Did I hear you say the participant does not need to demonstrate knowledge and understanding of what he or she might be doing? Does Orange County, California, come to mind?

Dr. WALSH. Well, in the case of financial derivatives and large——

Mr. CONAWAY. We were talking about your—but it is odd that you would say you don't want informed participants.

Dr. WALSH. Oh, no, sir. That is not at all what we are saying. We absolutely have an extensive preparation and briefing before the members of the Exchange execute the contract to commit to the terms of the Exchange. We facilitate their participation and reporting and annual compliance and it is really a facilitative audit, in fact, to help them get their numbers and data in order. But many of the members of the Exchange choose not to, because they don't need to, participate in the trading part.

Mr. CONAWAY. Okay.

Dr. WALSH. And they have that as an option. And to say you are going to be trading some sophisticated, high-value commodity, your financial instruments—is not the correct assessment in this particular case.

Mr. CONAWAY. Okay. How do you settle arguments between your participants?

Dr. WALSH. We generally don't have many arguments. We have an overnight payment and delivery process. Nobody has failed on the payment and delivery terms and we do have a committee structure that is the governance process. Members of the Exchange participate in a self-regulatory structure, sir.

Mr. CONAWAY. And on your disclosure sheet, you got contracts of some sort with USDA? What are those contracts?

Dr. WALSH. I am sorry, sir?.

Mr. CONAWAY. On your disclosure page you have contracts with the USDA.

Dr. WALSH. Oh, yes, sir. The USDA has provided, through NRCS, first, a small grant and then a little bit bigger one, to help us to engage expert verifiers to do field inspections, in particular, on conservation tillage plots, on grass planting plots and now on rangeland management fields. It is a fairly expensive initial cost and we are trying to build up the capacities, bringing in folks like SES, out of Lenexa, Kansas, bringing in forestry and farm experts to do infield inspections, so we have integrity underlying the product.

Mr. CONAWAY. Why would the participants not pay for that?

Dr. WALSH. Well, I think we are going to move to that sort of model, but my sense is the good folks at USDA thought that this was a public benefit to test out these ideas and to form and revise the protocols and to get that talent base built up. We do envision a self-funding model in the not-too-distant future.

Mr. CONAWAY. Okay. Thank you, Mr. Chairman, I yield back.

Mr. ETHERIDGE. I thank the gentleman. The gentleman from Georgia, Mr. Marshall, for 5 minutes.

Mr. MARSHALL. Thank you, Mr. Chairman. I guess I am pleased to see the sensitivity of our staff in putting Mr. Carlson between Mr. Sprecher and Dr. Newsome and Mr. Duffy. We appreciate the service that you are providing us, sir.

Just real briefly, Mr. Sprecher, following up on Mrs. Boyda's question. How do we keep the baby and toss the bathwater with regard to this exempt market issue, the 2(h)(3) issue? Real briefly.

Mr. SPRECHER. Sure. I think the CFTC is, itself, trying to do that, but if Congress wants to play a role, I think it can help codify some of the things that they are doing, which is continued reporting. The area where I think there is some vagary that could use some direction from Congress is that if a problem is seen, what action should be taken and who should take. For example, should ICE become a self-regulated type organization where it can direct market participants or should the CFTC, itself, direct market participants? We have told the CFTC we are happy to play either role.

Mr. MARSHALL. In trying to figure out what direction we should take, perhaps we should take some guidance from the CFTC. If the CFTC feels that it is able to deal with the worries about inappropriate manipulation, *et cetera*, with the tools that it has at the moment, then perhaps the CFTC might tell us that it doesn't need additional legislation from Congress. Contrariwise, if it doesn't, would that be where we should seek our guidance?

Mr. SPRECHER. I hesitate in telling somebody like you what to do, but I do think that the——

Mr. MARSHALL. I need lots of advice on this issue.

Mr. SPRECHER. I do think, as some of my colleagues have pointed out, there is a general awareness, in our industry, in Congress and the CFTC, a potential for problems that need to be corrected and I am cognizant of the fact that the acting Chairman said he is at the outer limits of what he can do, so I suspect that is a signal to Congress that he could potentially use some help.

Mr. MARSHALL. CFTC funding, I think everybody agrees that it is a challenge, simply to keep the kind of good folks working for the CFTC that we really need to have. In order for them to be competent, to appropriately regulate, we have got to increase their salaries substantially and if the budget doesn't grow substantially in order to do that, then the staffing has to diminish dramatically and when you diminish the staffing, you have a quantity problem. It is just simply not enough people.

And a number of people have suggested that the industry should be bearing the cost of this. It is the way the SEC works. Just brief comments about that. I want to talk about energy and Graves-Barrow here if we have an opportunity, so very brief comments about where should the funding come from? It seems to me to be a fairly minor expense compared to the size of the industry and that the industry ought to step up and offer to carry some of this cost. And I guess this is principally directed to the exchanges.

Mr. DUFFY. Yes. If I may, Mr. Chairman, answer that question?

Mr. MARSHALL. I appreciate the promotion, thank you.

Mr. DUFFY. No. Congressman, thank you. We have a big difference in this because the budget for the CFTC, as I have outlined in my testimony, a lot of budgetary needs go to trading or chasing off-exchange, unregulated activity and that is a big concern for us, that the regulated exchanges should bear that cost. Also——

Mr. MARSHALL. Can I interrupt?

Mr. DUFFY. Yes, sir.

Mr. MARSHALL. So if we—I suspect your view is that somehow we ought to make some adjustments legislatively that limits the extent to which this kind of thing can go on off-exchange, which means it would come on to exchange, so at that point, you would be willing to carry all the costs?

Mr. DUFFY. Well, again, that is not—what we are saying is when there are hundreds of millions of dollars being lost and fines being levied after the horse has been out of the barn, it is a little difficult to collect those fees because the people are gone. Again, our people do pay a fee to the National Futures Association for regulation, which a lot of that CFTC regulation has been off-loaded to the NFA, so we already do participate, our clients do, in paying for regulation to the agency.

Second, we are talking about an industry that has got half a million in commodity accounts in the U.S. *versus* several millions of contracts of equities and we have only a handful of people providing deep pools of liquidity that benefit multiple constituencies, that that would not happen if they had to pay a user fee on top of that. We are talking about a fee or a tax before they even made or lost a profit on each and every one of their transactions and these folks can go overseas quite quickly.

Mr. MARSHALL. I apologize for interrupting. My time is about to expire. We have votes coming up. It would be very helpful to us, for all of you, and I am sure you will be doing so, but if you could comment in writing about the proposed Graves-Barrow legislation and assuming that there is a problem here, what sort of solution is appropriate, in your views. Thank you, Mr. Chairman.

Mr. ETHERIDGE. I thank the gentleman and if you would submit that in writing, it would be helpful. We will stand in recess probably for about 15 minutes, soon as we get these two votes. We are in the last 3 or 4 minutes of one vote and we have one 5 minute vote and then we will back. Thank you.

[Recess]

Mr. ETHERIDGE. We thank you very much for waiting on us. I recognize the gentleman from Kansas for 5 minutes.

Mr. MORAN. Mr. Chairman, thank you very much. A number of our colleagues on this Committee have zeroed in on issues related to the regulation of ECMs and on the testimony of Mr. Sprecher, he indicates that most energy swap contracts traded on ICE are niche OTC products that are not amenable to the application of such requirements, urges the Subcommittee to stay within the current regulatory framework and allow CFTC to make adjustments that may be appropriate for a few particular products. Is the division between you and your colleagues, to whatever side of the room that is, is this the issue about the few regulated products, is that the distinction that we are having a discussion about?

Mr. SPRECHER. Well, I think Dr. Newsome and I could actually probably even agree on what the products are and I think the industry, generally, the energy industry would generally support us in our views, given all the conversations we have had. I think what we are talking about now are okay, having figured out the specific products should have more, let us call it, oversight, what form and how should——

Mr. MORAN. It is not the products. It is the level of regulation, the level of oversight?

Mr. SPRECHER. Correct. And its nuance diversions of that, not whether or not it should exist at all.

Mr. MORAN. Mr. Carlson, the CFTC made some changes in their rules and regulations in regard to outside directors, I would guess, 6 months ago. Are you able to easily comply with those new rules and regulations? And do you have a sense, that with a new Chairman of the CFTC, there is flexibility there in meeting the criteria that was established for outside directors?

Mr. CARLSON. Well, we are complying with the Safe Harbor provisions under the core principles that they provided us. We are not necessarily in favor of it coming from the top down, forcing us to make these changes, but I think we are trying to put the best face on it as possible and use this as an opportunity for us to try to make some changes that we wanted to make internally. So in some respects, we are not necessarily that opposed to what happened, but we did not like the fact that it was coming down, forcing us to make those changes, as opposed to us moving on our own.

Mr. MORAN. So you would have no suggestions to this Subcommittee in regard to legislative changes as we discuss reauthorization about those rules?

Mr. CARLSON. Well, what we have proposed, as I put in my testimony, was the fact that there are little nuances here and there, and one particular one that kind of bothers is, as a small exchange, is that there is a regulatory oversight Committee consisting of these three public directors and that is under the Safe Harbor provision. It seems silly, in our respect, to have to have that because we don't have some of the underlying problems that were perceived at the other exchanges from a regulatory side. And we only have three staff individuals that will be supervised under the three public directors, so again, it is a little bit top-heavy, to say the least.

Mr. MORAN. Do you have any sense that the CFTC, with new leadership, new Commissioners, has a different approach to this topic?

Mr. CARLSON. I think we are very pleased with Acting Chairman Lukken and we are in contact with them and we are hoping there may be some changes yet to come, prior to——

Mr. MORAN. From my perspective, that would be a good thing and much less cumbersome and more timely than what this Committee might be able to do, based upon our history with reauthorization.

Mr. CARLSON. I agree. Thank you.

Mr. MORAN. Thank you. Let me ask one other question, just a broader question is that much of the testimony has been about examples of things that have occurred in the markets that perhaps suggest the need for additional regulation. We look, retrospectively, back and make suggestions for what we ought to do with reauthorization. Do any of you see future trends in the futures industry that we need to be made aware of so that we are legislating proactively, as compared to responding to issues that have arisen in the past that perhaps need our attention now? Anything out there in the industry that we ought to be aware of?

Dr. NEWSOME. Congressman, I think the issue that we are talking about with regard to ECMs and triggers for more regulation certainly could be a trend. Right now, it is contained to one marketplace and we are trying to address it specifically. I think if Congress takes the targeted approach that we recommended, I agree with Mr. Sprecher, that we have the exact idea of what product would, at least initially, be encompassed.

I think one area that I would slightly disagree with Mr. Sprecher on is the authority that the CFTC currently has. The CFTC currently has special call authority to collect information. That information is collected after the fact and we are looking at a preventative solution here with regard to these recommendations, so I think the mandated large trader reports needs to be one of the components. Second, with regard to position accountability or the self-regulatory organization, the CFTC does not have the authority to oppose those requirements on EMCs today.

Mr. MORAN. Dr. Newsome, thank you. I am pleased to have asked an open-ended question to give you the opportunity to answer the question that you would like to answer. Mr. Chairman, thank you for the time and my time is expired.

Mr. ETHERIDGE. I thank my friend for his comments and I would say, before we dismiss this panel, there may be additional questions by Members to you and we would ask that you respond to those as quickly as possible for the Committee. And with that, if the gentleman from Kansas has a closing comment?

Mr. MORAN. Mr. Chairman, no. I would like to proceed with the next panel. I appreciate the testimony we have heard today and again, hope that we have some results from these continual discussions about reauthorization.

Mr. ETHERIDGE. I thank the gentleman. Let me thank each of our panelists. You have been most helpful this morning in your comments and I can assure you that we will be in touch with you, other Members may, for information as we move forward with this reauthorization. Thank you very much and we will now welcome the second panel.

Let me welcome our second panel to the table and thank you for coming. First is Mr. Roth, who is President and CEO of National Futures Association in Chicago. Second is Mr. Zerzan, Counsel and Head of Global Public Policy, International Swaps and Derivatives Association on behalf of ISDA and the Securities Industry and Financial Markets Association here in D.C.; Mr. Damgard, President of Futures Industry Association here in D.C.; Ms. Becks, President and CEO of Campbell & Campbell, Incorporated, on behalf of the Managed Funds Association in Baltimore; and Mr. Brodsky, Chairman and CEO of Chicago Board Options Exchange on behalf of the U.S. Options Exchange Coalition out of Chicago.

Let me thank each of you and Mr. Roth, if you would, begin when you are ready and I would ask all the witnesses, if you would, try to limit your time to 5 minutes. It looks like we could have another vote somewhere around noon or shortly thereafter, which hopefully will give us time to get most of our stuff in if we move and we aren't joined by others, we may get it all in. So Mr. Roth, we will begin with you, please, sir.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CEO, 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, which is the industry-wide self-regulatory body for the futures industry. The first panel this morning touched on a number of really crucial issues, whether it is 2(h)(3) or the CFTC's exclusive jurisdiction. Those are all important issues and we are glad that they are being debated here.

If I could this morning, though, I just wanted to remind the Committee that we have some unfinished business related to customer protection issues in the off-exchange retail forex space. I testified in both 2003 and 2005 that I felt that certain provisions of the CFMA, along with subsequent case law, had created situations where unsophisticated retail customers were particularly vulnerable in the off-exchange forex area. If I could, I would like to take a couple of minutes and describe the context of those issues, describe in greater detail some of the problems we have seen and some possible solutions.

First of all, when I testified in 2003, I told the Committee that the forex dealer/members of NFA at that time held about $170 million in customer funds. Today, 4 years later, that number has grown to over $1 billion in customer funds. So that is pretty dramatic growth and it has been accompanied by some pretty dramatic problems. Our forex dealer/members at NFA constitute less than 1 percent of our overall membership, but those members account for over 20 percent of the customer complaints that are filed in our arbitration program; they account for 50 percent of NFA's enforcement docket; they account for 50 percent of the emergency actions that we have had to take this year.

I think there are a number of provisions in the Act that have contributed to those problems and I would like to discuss them briefly, if I could. If you look at the firms that have created most of the problems, they share a couple of traits. First of all, most of these firms, although registered as FCMs, aren't really FCMs, at all, at least, not as the way that term in defined in Section 1(a)(20) of the Act. These firms don't do any exchange traded futures business, at all. They get registered as FCMs for the sole purpose of qualifying, under the Act, to do off-exchange retail forex. So in that sense, they are not really FCMs, at all.

The second trait that these firms often share, not always, but very often, is that they tend to be thinly capitalized, which is of particular concern because frankly, the risks that operating a dealer market include are substantially different than the risks involved in a traditional FCM business, where you are acting as an agent for your customer. And second, there is no clearing organization standing behind these off-exchange products, so that the forex dealer is really the sole source to ensure the fulfillment of financial obligations to customers.

So for those two reasons, I think that there needs to be a substantially higher capital requirement for forex dealers than for traditional FCMs. So really with respect to those two problems, I think we would urge Congress to limit the FCMs that can act as counterparties to retail forex transactions to those FCMs that are real FCMs, that are actively engaged in the activities described in Section 1(a)(20) of the Act and to those firms that have at least $20 million in capital.

The next problem I just wanted to discuss is one that this Committee dealt with in H.R. 4473 and I applaud you for doing that, and it is the solicitor issue, what we have referred to as the solicitor issue. The CFMA provides that if a counterparty to the retail forex transaction is an FCM, then that whole transaction is outside the regulatory authority of the Act, which means that the person soliciting the customers, the person actually working the phones and selling the product to the retail customers, is not required to be registered, not required to be regulated at all and H.R. 4473 addressed that issue and that is good.

What I am telling you is that in the last couple of years we have seen a slight variation on that theme where now we have firms that become active as the equivalent of commodity pool operators or commodity trading advisers, but again, they limit themselves to off-exchange retail forex transactions with the result that those pool operators and trading advisers aren't required to be registered. They are not regulated and those customers don't receive the same regulatory protections as regular CPO/CTA customers. I think the H.R. 4473 approach on the solicitor just needs to be modified slightly to capture the CPO/CTA elements, as well.

And finally, Mr. Chairman, let me just conclude by just mentioning again, briefly, the *Zelener* case. As I mentioned before in my testimony, in our view, the problem with the *Zelener* case is that it gives the scammers a blueprint, directions on how to write their contracts to avoid CFTC jurisdiction. In that sense, the problem with *Zelener*, it is not a forex problem, *per se*, it is a problem with unregulated retail futures markets. That is why we supported, last time, a broad *Zelener* fix rather than the narrow fix that was in H.R. 4473. We continue to think that the broad fix is the better fix, but in light of all the problems we have had, we also believe that a fix now is infinitely better than a fix later. And we continue to support a broader fix, but what we urge most is a prompt resolution of these issues and prompt reauthorization of the CFTC and we will support any sort of proceeding or any sort of proposal that helps us achieve those ends.

So Mr. Chairman, thank you very much and I would be happy to answer any questions.

[The prepared statement of Mr. Roth follows:]

PREPARED STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CEO, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Etheridge 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 continues the reauthorization process. NFA is the industry-wide self-regulatory organization for the U.S. futures industry. As a regulator, NFA is first and foremost a customer protection organization.

I testified before this Subcommittee in 2003 and in 2005 about off-exchange forex futures that were being sold to retail customers. I stated then and believe now that certain provisions of the Commodity Futures Modernization Act of 2000 and subsequent case law had the unintended consequence of making unsophisticated, retail customers the prey of fly-by-night operators. Let me put these issues in some overall context, describe in detail the problems we have seen in the statute and share with you some proposed solutions.

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 Commodity Exchange Act ("Act") unless the counterparty was an "otherwise regulated entity," such as a bank, a broker-dealer or an FCM. When I testified here in 2003, I told you that NFA Member FCMs held $170 million in retail customer funds trading off-exchange forex. Four years later, that number is now over $1 billion. With this dramatic growth there have been some pretty dramatic problems.

Members acting as counterparties to retail forex transactions account for less that 1% of NFA's membership. Unfortunately, they also account for over 20% of the customer complaints filed with our arbitration program, over 50% of NFA's current enforcement docket and over 50% of the emergency enforcement actions NFA has taken over the last year.

There a number of problems in the current statute that have contributed to these problems. If you look at the firms that have caused virtually all of the customer protection problems in retail forex, they share a couple of traits. First of all, they are not really FCMs at all. Congress intended to allow FCMs, along with banks, broker-dealers and insurance companies, to act as counterparties to retail forex transactions because they are all "otherwise regulated entities." The wording of the statute, though, opened the door for firms that are not really FCMs to take advantage of the FCM exemption. Firms became registered as FCMs that are FCMs in name only—they do no exchange-traded futures. They are registered as FCMs solely to qualify to do retail forex business. To make matters worse, due to a further anomaly in the statute, the Act currently does not provide the CFTC with any rulemaking authority over these firms at all. Clearly, Congress did not intend to allow firms that are FCMs in name only to act as counterparties to retail forex futures. Congress should fix this problem by limiting the FCMs that can act as counterparties to those that are primarily and substantially engaged in the activities described in Section 1(a)(20) of the Act.

The second trait that marks the problem firms in retail forex is that most, though not all, have been thinly capitalized. Congress long ago recognized that acting as a dealer involves greater risk than acting as an agent in futures trading, the way a traditional FCM does. That is why Congress in 1978 imposed a $5 million net worth requirement for firms granting dealer options and why the CFTC created a $2.5 million capital requirement for leverage transaction merchants in 1984. Congress should amend Section 2(c) of the Act to require FCMs acting as counterparties to retail forex transactions to maintain minimum capital of at least $20 million. NFA has raised the capital requirements for forex dealers several times but this congressional action could ensure that firms can meet their obligations to their customers and have a significant financial stake in their business.

NFA is strongly supportive of both of these solutions to the customer protection problems we have experienced with retail forex. We are also strongly supportive of giving the CFTC rulemaking authority over FCM only firms (i.e. those that are not otherwise enumerated in Section 2(c) of the Act to act as retail forex counterparties). It is simply paradoxical to call these FCMs "otherwise regulated" when, other than anti-fraud jurisdiction, there is no Federal regulatory oversight of these firms' activities.

There's one more forex problem I should mention that poses significant customer protection issues based upon the wording of the CFMA. Specifically, the wording of the statute currently only requires the counterparty to these transactions 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 selling 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 do not think that's what Congress intended at all, and H.R. 4473 passed by the House in 2005 contained 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 registered with the CFTC and subject to its jurisdiction. We, of course, support this amendment.

In the last few years we have also seen a growing number of firms acting as trading advisors and pool operators that trade exclusively off-exchange forex. Under the current statute, these firms are not required to be registered and their customers do not receive the same regulatory protections as customers of CPOs and CTAs that trade on-exchange. Some of these unregistered firms tout outlandish performance claims that cannot be substantiated. We believe that H.R. 4473's amendment should be extended to require those persons that manage accounts or pooled investment vehicles on behalf of retail customers to register and be subject to the CFTC's jurisdiction.

The last issue I wanted to discuss brings us back to the *Zelener* case. As you may recall, in the *Zelener* case the CFTC attempted to close down a boiler room selling off-exchange forex trades to retail customers. 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.

For a short period of time, *Zelener* was just a single case addressing this issue. However, time has proven that the CFTC cannot litigate itself out of the *Zelener* problem. Since 2004, various Courts have continued to follow the Seventh Circuit's approach in *Zelener* causing the CFTC to lose enforcement cases relating to forex fraud. Therefore, *Zelener* allows completely unregulated firms and individuals through clever draftsmanship to sell to retail customers contracts that look like futures and act like futures outside the CFTC's jurisdiction. The bottom line is that these Court decisions make 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 being victimized by high-pressured sales pitches for foreign currency futures look-alike products. 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.

NFA recognizes that H.R. 4473 addressed the *Zelener* problem with regard to retail forex. NFA applauds those efforts in addressing the current scam of choice—forex—among fraudsters and believes that any future reauthorization legislation should at the very least incorporate H.R. 4473's approach to this issue. However, NFA remains concerned that the rationale of the *Zelener* decision and its progeny 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.

NFA and the exchanges have developed a fix to *Zelener* that goes beyond forex and does not have unintended consequences. Our approach codifies the approach the Ninth Circuit took in *CFTC* v. *Co Petro*—which was the accepted and workable state of the law until *Zelener*—without changing the jurisdictional exemptions in Section 2(c) of the Act. In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts if the retail customer does not have a commercial use for the commodity or the ability to make or take delivery. This presumption is flexible and could be overcome by showing that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements in the underlying commodity.

This statutory presumption would not affect either the interbank currency market or already regulated instruments like securities and banking products. It would, however, ensure that scammers cannot tailor their written agreements to sell leveraged commodity products to retail customers for speculative purposes in a completely unregulated environment. Moreover, it protects retail customers by giving the CFTC the power to shut down unregulated boiler rooms and freeze their funds.

While NFA continues to believe that the solution to *Zelener* should go beyond forex, we recognize that H.R. 4473's narrow *Zelener* fix would be a marked improvement over the current state of the law. If Congress adopts only a narrow *Zelener* fix and boiler rooms move to other commodities using *Zelener*-type contracts, then Congress must be willing to re-open the Act before the next reauthorization to consider resolving this issue completely.

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 and from the CFTC's role in implementing the Act. We look forward to working with this Subcommittee, other Congressional committees, the CFTC, and the industry to address the important customer protection issues outlined above.

Mr. ETHERIDGE. Thank you, Mr. Roth. Mr. Zerzan.

STATEMENT OF GREGORY P.J. ZERZAN, COUNSEL AND HEAD, GLOBAL PUBLIC POLICY, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, WASHINGTON, D.C.; ON BEHALF OF SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. ZERZAN. Thank you, Mr. Chairman and Ranking Member, for inviting ISDA and SIFMA to testify today. Collectively, ISDA and SIFMA represent over a thousand entities that participate in both the on-exchange and over-the-counter markets. These entities range from financial services companies to manufacturers to insurance companies to parties that participate both as market makers as well as end-users of these products.

At a time when commentators are increasingly calling for the adoption of a principles-based approach to financial services regulation, it is important to remember that this Committee got there first and the adoption of the Commodity Futures Modernization Act of 2000 represented a momentous achievement in terms of financial services legislation. The financial service industry, as a whole is tremendously important to our economy. It is the third largest contributor to GDP and one in every 19 jobs in this country is in the financial services sector.

The Commodity Futures Modernization Act has allowed both on-exchange and over-the-counter derivatives business to explode in the United States and it is the leadership of this Committee which played a leading role in ensuring that that would happen. Nevertheless, in the time since the passage of the CFMA, the rest of the world has caught up to the fact that the financial services sector is a tremendous generator of economic growth. As several reports this year have already noted, the United States leadership, as the premiere center for financial services, is increasingly under assault.

The world's largest derivatives exchange, the Chicago Mercantile Exchange, is in the United States, but it is followed closely by two European-based entities. In the over-the-counter markets, United States leadership has actually succumbed to that of the UK: 43 percent of the over-the-counter derivatives business is done in the United Kingdom, compared to 24 percent in the United States.

So what we have seen is an issue arise around the question of what can the United States do to increase its competitiveness in this area. The prudent leadership of the Commodity Futures Trading Commission ensures that the U.S. remains a very attractive market for over-the-counter derivatives, but regulatory uncertainty has been cited as a reason why some market participants choose to go overseas. In that vein, with the recent actions of the Federal Energy Regulatory Commission, we see some of the uncertainty that market participants are wary of. With respect to reauthorization, then, ISDA and SIFMA have the following recommendations.

First, we think Congress should provide CFTC with the resources necessary to meet its staffing and IT procurement needs.

Second, the Congress should consult with the President's Working Group to determine if a definable market problem in need of a legislative solution exists. To the extent that the President's Working Group and Congress are able to identify a problem, then any such solution should be narrowly tailored to address that problem in a way that imposes the least cost on market participants. Last, we would urge that Congress reaffirm the exclusive jurisdiction of the Commodity Futures Trading Commission with respect to transactions on a registered exchange involving energy commodity derivatives.

We thank the Committee for its continued leadership and we are happy to answer any questions.

[The prepared statement of Mr. Zerzan follows:]

PREPARED STATEMENT OF GREGORY P.J. ZERZAN, COUNSEL AND HEAD, GLOBAL PUBLIC POLICY, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, WASHINGTON, D.C.; ON BEHALF OF SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. Chairman and Members of the Committee:

Thank you very much for inviting ISDA and SIFMA to testify today regarding reauthorization of the Commodity Exchange Act. As you know this law is of great importance to users of privately negotiated derivatives, and in this time of increasingly competitive global markets your continued thoughtful leadership in this area is greatly appreciated.

About ISDA and SIFMA

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 810 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Market Association, is based in Hong Kong.

The Success of the Commodity Futures Modernization Act

The derivatives industry is global in scale, with important centers of business existing in Europe and Asia as well as the United States. In that context, much of the business is managed and transacted locally, and has benefited from the U.S. legal and regulatory scheme.

The Commodity Exchange Act, as amended by the Commodity Futures Modernization Act of 2000, serves as a model for financial services legislation. At a time when commentators are increasingly urging the US to adopt a "principles-based" approach to financial market regulation it is important to note that this Committee achieved just that seven years ago. The Act provides a simplified approach to regulating on-exchange transactions in commodities while providing legal certainty for privately negotiated derivatives. By allowing market participants to chose the type and level of regulation they desire for their transactions the law affords the opportunity for maximum flexibility at minimum cost. This flexibility to choose among different types of products and markets has proven to be of tremendous benefit.

Since passage of the law in December of 2000 the derivatives business, both on exchange and off, has grown explosively. Since passage of the law U.S. dollar denominated on-exchange futures activity has grown 128%; US dollar denominated OTC activity, meanwhile, has increased 207%.[1] There is no question that this incredible growth has been spurred by the clarity of the law and the prudent oversight of the Commodity Futures Trading Commission.

The growth of the derivatives industry has meant the creation of a world of new risk management tools for American businesses and investors. It is now possible for a farmer to hedge against the risk of adverse weather affecting his crops, a pension fund manager to protect his retirees against the bankruptcy of a corporation whose debt it holds, a bank to protect against the default of loans it holds on its balance sheet, and an individual to protect against declining home values. All of these innovations have made the world financial system more resilient and allow businesses and individuals to focus on their core activities while minimizing their worries about events beyond their control.

Accompanying the growth in the derivatives business have come jobs and revenue for the United States. The financial services industry contains 5 percent of private sector jobs and produces 8.1% of GDP, making it the third largest sector of the US economy.[2] Nearly one in every 19 jobs in the country is in financial services.[3] Many of these jobs are at the cutting edge of innovation, creating a large number of patentable technologies.

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[1] Figures for US dollar denominated contracts do not provide a perfect substitute for US-based activity, but they do provide the most reliable available figures. OTC figures include interest rate, equity and foreign exchange contracts but do not include other commodities such as energy or precious metals.

[2] Interim Report of the Committee on Capital Market Regulation, page ix, November 30, 2006.

[3] Sustaining New York's and the US' Global Financial Services Leadership, page 10, January 2007.

The InterContinental Exchange, headquartered in Atlanta, provides an example. This American company employs over 500 people and has a market capitalization of over $9 billion; it is also on the forefront of creativity in both financial and high-tech innovation. It is no exaggeration to say that, were it not for the Commodity Futures Modernization Act of 2000, this highly successful US company would not be providing the jobs and revenue to the American economy that it is able to contribute thanks to that law.

Competitive Challenges to the U.S. Financial Services Industry

The tremendous economic growth engine that is the financial services industry has not gone unnoticed by the rest of the world. In Europe and Asia governments are rapidly working to reduce overly burdensome regulation in order to attract financial services business. As noted by New York Mayor Michael Bloomberg and Senator Charles Schumer in the letter accompanying their report on US financial services competitiveness, "in today's ultra-competitive global marketplace, more and more nations are challenging our position as the world's financial capital."[4] Indeed, in the area of derivatives America's lead has been more significantly challenged than elsewhere. Although the US remains home of the world's largest derivatives exchange (the Chicago Mercantile Exchange), it is followed closely by pan-European exchange Euronext.liffe[5] and the German-Swiss exchange Eurex. In the area of OTC derivatives, meanwhile, the US has lost its lead to the United Kingdom. The UK plays host to 43% of the world's OTC derivatives business, compared to 24% for the US. These figures are an increase of 7% and 6%, respectively, between April 2001 and April 2004.[6]

Part of the reason the UK has moved ahead of America in the OTC derivatives business has been attributed to regulatory advantages from operating out of London. One U.S. based business leader was quoted as saying "People feel less encumbered overseas by the threat of regulation and so are more likely to think outside of the box."[7] An example of this threat is the uncertainty imposed on market participants by efforts of the Federal Energy Regulatory Commission to regulate activities which appear to fall within the purview of the exclusive jurisdiction clause of the Commodity Exchange Act. A lack of clarity and legal certainty as to what activities are covered under which regulatory regime serves as a strong disincentive for doing business in the US.

Despite the loss in volume leadership in OTC derivatives the United States remains the source of many of the innovations occurring in that industry. The legal and regulatory certainty provided by the Commodity Futures Modernization Act and the CFTC have encouraged the creation of new products by American financial services firms. Nevertheless the loss of US leadership in the OTC business should be a worrying development for policymakers hoping to encourage growth in a vital US economic sector.

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[4] Ibid.

[5] Underscoring the global nature of these markets it is worth noting that Euronext.liffe is a subsidiary of NYSE Euronext, the holding company created by the combination of NYSE Group, Inc. and Euronext N.V., on April 4, 2007.

[6] Report on Derivatives, City Business Series, International Financial Services London, March 2006.

[7] Sustaining New York's and US' Global Financial Services Leadership, page 56.

No doubt this concern is why Congress recently directed that "Congress, the President, regulators, industry leaders, and other stakeholders should take the necessary steps to reclaim the preeminent position of the United States in the global financial services marketplace."[8]

Countervailing Concerns Regarding Reauthorization

Unfortunately, these concerns regarding a loss of US economic competitiveness come at the same time some end users in the energy market have complained that the prices they pay for certain commodities have been distorted. If true, these allegations would be worrisome not only for the end users, but for all market participants. In the long run no one benefits from markets which do not adequately reflect the forces of supply and demand, which is why the market users represented by ISDA and SIFMA strongly support continued vigorous oversight and, where wrongdoing is detected, prosecution, by the CFTC.

Fortunately for all market participants there does not appear to be strong evidence supporting the existence of widespread market abuse. In those cases where market abuse has been attempted the CFTC has been quick to act, and appropriately so. Nevertheless, despite the claims of some consumer and municipal groups, the case has not been made that fundamental changes in the law are necessary. It would be imprudent and damaging to America's companies and economy to change what has been a very successful law without conclusive evidence that changes are necessary to address a specifically identified problem.

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[8]Section 8007 of H.R. 2272, the America Competes Act (P.L. 110-69), provides:
It is the sense of the Senate that--

(1) Congress, the President, regulators, industry leaders, and other stakeholders should take the necessary steps to reclaim the preeminent position of the United States in the global financial services marketplace;

(2) the Federal and State financial regulatory agencies should, to the maximum extent possible--

(A) coordinate activities on significant policy matters, so as not to impose regulations that may have adverse unintended consequences on innovativeness with respect to financial products, instruments, and services, or that impose regulatory costs that are disproportionate to their benefits; and

(B) at the same time, ensure that the regulatory framework overseeing the United States capital markets continues to promote and protect the interests of investors in those markets; and

(3) given the complexity of the financial services marketplace, Congress should exercise vigorous oversight over Federal regulatory and statutory requirements affecting the financial services industry and consumers, with the goal of eliminating excessive regulation and problematic implementation of existing laws and regulations, while ensuring that necessary investor protections are not compromised.

Recommendations

The Commodity Exchange Act has provided a sound basis for the operation of both the exchange traded and privately negotiated derivatives businesses. In order to build upon that success ISDA and SIFMA recommend that Congress consider the following actions:

1) Provide the CFTC with the resources necessary to meet its staffing and IT procurement needs;
2) Undertake no changes to existing law in the absence of concrete evidence which conclusively demonstrates the existence of a market failure. The President's Working Group on Financial Markets should be included in any review of evidence purporting to show the existence of a market failure and the need to amend existing law.
3) In the event Congress and the President's Working Group are able to clearly identify a market failure, they should narrowly tailor any proposed changes to those areas which will impose the least cost while providing the greatest benefit to market users.
4) Reaffirm the exclusive jurisdiction of the Commodity Futures Trading Commission with respect to transactions on a registered exchange involving energy commodity derivatives.

Conclusion

The position of the United States as a center for financial services innovation is imperiled as perhaps never before. By adopting the Commodity Futures Modernization Act seven years ago Congress took great strides forward in promoting the growth of an important sector of the U.S. economy. To the extent changes in the law are proposed they should be viewed with an eye towards increasing U.S. competitiveness, and with a skeptical eye towards any proposals which would have the effect of increasing the attractiveness of foreign markets relative to the U.S. If concrete evidence of a market failure exists it should be identified and addressed in a narrow, targeted manner. However, the absence of any such evidence thus far strongly cautions against any changes. This approach would be consistent with Congressional intent when it enacted into law the "America Competes Act" last month.

This Committee has shown strong leadership in the past in promoting fair and competitive derivatives markets. This benefits market participants, end users, and ultimately all consumers, who enjoy the price protection that comes from more stable markets. Thank you for your continued leadership.

Mr. ETHERIDGE. Thank you. Mr. Damgard.

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

Mr. DAMGARD. Chairman Etheridge, Ranking Member Moran and Members of the Subcommittee, I am John Damgard, President of the Futures Industry Association and thank you very much for the opportunity to appear today.

FIA has three general points to make. Number one, we endorse CFTC reauthorization. We support CFTC exclusive jurisdiction and we oppose any major changes to the CFMA. FIA believes that the CFTC is an excellent agency that fulfills its statutory mission in an efficient and effective manner. CFTC's past and present leadership is to be commended for this record. The CFTC does, indeed, deserve to be reauthorized. Recently, a controversy has arisen concerning the scope of the Commission's exclusive jurisdiction. There should be no controversy. In 1974, the House Ag Committee created both the CFTC and its exclusive jurisdiction to make sure that only an expert, specialized agency would regulate futures trading.

Congress knew that exposing futures exchanges, intermediaries and market participants to duplicative or conflicting regulation from other agencies with no expertise in futures markets would be a recipe for disaster. That is why Congress has made crystal clear that the CFTC's exclusive jurisdiction, where applicable, supersedes that of any other agency. As the courts have held, that means no other agency, whether it is the SEC, the FERC, the USDA or the states may police the futures markets. Any other result would threaten the competitiveness of U.S. futures markets.

This Subcommittee was the birthplace of the CFMA. That landmark legislation has allowed our markets to prosper and grow and even though FIA does not believe its full competitive promise has been realized, we would oppose major changes to the CFMA's framework. There are four specific substantive areas we expect the Subcommittee will consider in it deliberation and let me offer our views.

SRO reform: FIA supports the important role the exchanges, clearing organizations and NFA perform as self-regulatory organizations. Their expert market knowledge and close proximity to the trading markets is vital to its effective oversight. However, as exchanges are moved successfully into the for-profit world, their public interest duties have come into conflict with their private interests. That has affected public confidence in self-regulation. To address this concern, the CFTC has proposed a series of best practice reforms for SROs, including a Safe Harbor for an exchange when 35 percent of its Board of Directors are independent public directors. The CFTC has proposed some modest revisions to its new guidelines. FIA strongly supports these SRO reforms and urges the Commission to implement them as soon as possible.

Competition: Promoting fair competition was a goal of the CFMA. Although it has led to the creation of more new exchanges, it has not stimulated the kind of direct product competition that the CFMA envisioned and this is very disappointing. Competition leads to reduced costs, higher volumes, narrower spreads and greater innovation. Competition also is the best system for serving the interests of our customers. Exempt commercial markets, ECMs, in the energy space have been the one area of direct product competition under CFMA. ECM trades are principle-to-principle, not brokered, and my member firms are largely brokers, so you might expect me to oppose ECMs. We do not. We support them because ECMs serve as incubators for the successful training platforms of tomorrow. If you cut out ECMs, you cut out the competitive, innovative heart of the CFMA. With the merger of the Chicago Merc and the Board of Trade, some might argue that futures exchanges have become more concentrated than competitive and if this true, it is unfortunate because real competition leads to better service, lower fees for the customers.

Recently we have seen clearing fees reduced for some financial markets, but not on U.S. futures exchanges. With the explosive growth in futures trading volume, my members have asked me why they have not enjoyed similar clearing fees reductions and I do not have a good answer. I do know that competition and market structures are critical issues for customer service. Unless competitive forces materialize in our markets, FIA believes the CFTC should study the state of competition in our industry to make sure that we have the best market structure in place for serving our customers.

Energy: Everyone agrees that the price of energy is a critical element of our national economy. As a result of CFMA, our energy markets have experienced considerable innovation and increased competition without compromising the public interest. There is no regulatory gap for futures manipulation. The Commission uses a wealth of market surveillance techniques and an arsenal of enforcement weapons in its pursuit of what Chairman Lukken has labeled the agency's zero tolerance for price manipulation. FIA agrees with this emphasis. Price manipulation should be prevented whenever possible and never tolerated.

Some have questioned how well existing anti-manipulation defenses work when more than one energy market exists. Multiple trading facilities, like NYMEX and ICE only enhance the need for strong CFTC oversight. When two markets are competing directly, the CFTC's market surveillance staff must have ready access to all relevant large trader reporting. At the same time, FIA believes price manipulation is of little concern in one-off, non-standardized transactions between two eligible contract participants where the price affects the individual transaction, not a wider market. Those transactions should remain outside the CFTC's price manipulation authority.

Retail FX: FIA continues to support the legislation offered by the President's Working Group in 2005 to enhance the CFTC's power over retail FX transactions. This targeted, focused approach makes sense and should help the Commission to combat the boiler rooms and bucket shops that abuse customers.

And in conclusion, our last part is a familiar one and a critical one. FIA opposes the funding of the CFTC through a transaction tax. All taxpayers benefit from CFTC market oversight, therefore all taxpayers should pay for it. If the CFTC needs additional resources, and we believe they do, the Administration should request and Congress should appropriate the necessary funds, but a transaction tax would hit hardest those traders that provide essential market liquidity. It is therefore a bad idea whose time should never come.

Thank you for holding this hearing and I am happy to answer any questions.

[The prepared statement of Mr. Damgard follows:]

PREPARED STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Chairman Etheridge, Ranking Member Moran, 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. Our regular membership is comprised of 35 of the largest futures commission merchants (FCMs) in the United States. Among our 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.

As these statistics indicate, the clearing firms are the backbone of FIA's membership. Not surprisingly, the clearing firms are also the backbone of the futures industry. These firms underwrite the financial performance of their customers and provide the billions of dollars in capital that makes the U.S. futures clearing system widely respected as the world-wide hallmark of financial integrity. The U.S. futures exchanges are remarkably successful and profitable enterprises, as the price of their stock reflects. The futures clearing firms are a big part of that success story, a part often overlooked and sometimes underappreciated.

In 2000, 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, provide 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. The CFTC has done, and continues to do, an admirable job administering the provisions of the CFMA and the Commodity Exchange Act as a whole, adapting its regulatory authority to the dynamics of an ever-changing and ever-challenging market place.

FIA wholeheartedly endorses the reauthorization of the CFTC. 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.

Recently, a controversy has arisen concerning the scope of the Commission's exclusive jurisdiction. There should be no controversy. Exclusive jurisdiction was created in the House Agriculture Committee in 1974 to make sure that only the CFTC would regulate futures trading activity and conduct by futures exchanges, futures professionals and futures market participants. Congress made crystal clear in 1974 that the CFTC's jurisdiction, where applicable, supersedes the authority of other Federal agencies.

Congress actually anticipated the seeds of the current controversy when it enacted exclusive jurisdiction. The Federal Energy Regulatory Commission claims its cash transaction anti-manipulation authority allows it to police the futures markets themselves because futures prices are used in entering into cash transactions. But Congress knew that one purpose of futures trading is to provide pricing information that non-futures market participants can rely upon in their commercial dealings. To this day, futures price dissemination is one of the Congressionally-recognized public interests served by futures markets. 7 U.S.C. § 5(a). Given that economic reality, Congress knew that if cash market regulators, like FERC, could stretch their policing arm into the futures markets, futures exchanges, professionals and market participants would be subjected to regulation from multiple Federal regulators, including the Securities and Exchange Commission, Bureau of Mines, the Department of Agriculture, the Department of the Treasury, the Board of Governors of the Federal Reserve System as well as FERC.

Congress made a choice. In our view, the right choice. It said CFTC jurisdiction over futures was exclusive. The dictionary defines exclusive as "not shared with others." Congress adopted CFTC exclusive jurisdiction because it wanted the CFTC's jurisdiction not to be shared with others in order to prevent U.S. futures markets, professionals and market participants from bearing the cost of "duplicative or conflicting" regulation. And it wanted to entrust the nationally important economic activity in futures markets to the oversight of one expert regulator, the CFTC.

For over thirty years, CFTC exclusive jurisdiction has achieved Congress' objective because courts have uniformly accepted that Congress used the word "exclusive" so that the CFTC's jurisdiction would not be shared with other agencies. For over thirty years, these exclusive jurisdiction cases have arisen in two contexts: (1) where a Federal or state regulator sought to punish alleged misconduct arising out of transactions within the CFTC's jurisdiction or (2) where a Federal agency, like the SEC, had approved options or futures products under its regulatory regime that were really subject to the CFTC's authority.

The FERC's recent attempt to change the meaning of "exclusive" to "non-exclusive" falls into the first category. No court has ever accepted the position advanced by FERC. And no court should. Exclusive jurisdiction is vitally important to the proper functioning of the futures markets. It must be preserved.

FERC's latest assertion is that there is a regulatory gap in policing futures market manipulation. Nothing could be further from the truth. The CFTC has comprehensive, time-tested futures price anti-manipulation authority. It vigorously enforces the law. FERC and the CFTC should work together. Each has enormous and important responsibilities. By double-teaming futures trading, however, FERC is actually diverting resources from those duties. Exclusive means just what it says. It was sound policy in 1974 and remains sound policy today.

In terms of specific areas for reform of the existing regulatory structure, FIA is considering a few proposed areas of technical improvement. Rather than discuss them in detail at this time, FIA would prefer to focus on bigger picture issues and continue its dialogue with the Commission and others in the futures industry on the areas where modest reform would be helpful. Perhaps, in some areas, an administrative solution can be found and no statutory amendments will be necessary. In light of the Subcommittee's interest in moving a reauthorization bill, FIA will expedite this process so that the Subcommittee may give timely consideration to any amendments the Commission might recommend.

At this stage of the process, we want to let you know the views of our members in four areas: (a) SRO Reform; (b) Competition; (c) Energy; and (d) Retail FX Transactions.

SRO Governance and Rule Approvals

FIA supports the important role that the exchanges, clearing organizations and the National Futures Association (NFA) perform as self-regulatory organizations (SROs). Given their expert 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, to its great credit, has conducted a comprehensive study of SROs in the futures industry, resulting in the promulgation last February of rules designed to reform SRO governance in many respects. FIA strongly supported the CFTC's efforts to get ahead of the curve on this issue and devoted considerable time and resources to answering the Commission's many inquiries on this subject over the years.

The Commission's newly adopted "best practices" are a balanced and sensible work product that resulted from its careful study. In the context of a Safe Harbor for compliance with applicable core principles for Designated Contract Markets, the Commission has identified sound and constructive "best practice" guidelines for DCM Board composition, the development of independent Regulatory Oversight Committees and improvements in the DCM disciplinary process. Most significantly, the safe harbor would be available to any DCM with a Board of Directors comprised of at least 35% public (independent, non-industry) board members.

FIA believes the Commission's best practices constitute a major step toward addressing the conflicts of interest inherent in for-profit self-regulatory bodies. SROs that serve both the public interest and private interests necessarily serve masters that at least sometimes conflict. Adding public directors to the board of these SROs brings balance to the resolution of those conflicts, and avoids the public perception that DCMs will sacrifice public interest responsibilities for the commercial interests of their shareholder and members.

The Commission published its final rules in this area in February and then proposed clarifying and technical amendments to the "public director" definition of its safe harbor. FIA strongly encourages the Commission to act as soon as possible on its proposed amendments and then implement fully its SRO reforms. FIA is confident these measures will increase public confidence in the self-regulatory protections afforded by DCMs under the CFTC's enlightened oversight.

The Commission's SRO study and safe harbor do not directly address one other area where FIA has expressed concerns—self-certification of DCM rules. As the Subcommittee no doubt appreciates, DCM rules impose important and sometimes costly mandates on intermediaries and market participants alike. Often they can be as important as Commission rules which are adopted after full compliance with the Administrative Procedure Act with its notice and comment requirements.

DCMs do not operate under any restrictions even approaching the APA. Their rule making procedures are often opaque to market participants and the public at large. Yet the CEA now allows SROs, primarily DCMs, to self-certify virtually all rule changes and make them effective immediately. (The only exception is for changes to terms and conditions of agricultural commodity futures contracts with open interest.) Commission prior approval of DCM rule changes is limited to those situations where a DCM affirmatively requests Commission approval.

FIA generally does not quarrel with the decision to grant DCMs self-certification powers. We do have considerable concern, however, that in some cases virtually industry-wide trading rules and other important mandates, including fee changes, are being imposed on market participants and intermediaries, including clearing firms, without any Commission prior review and certainly without any form of APA notice and public comment. We would urge the Commission, when it is requested, or decides, to review any rule submission from any registered entity to publish the rule submission for notice and comment under the APA. The law is clear that Commission action on registered entity rules is agency action under the APA. FIA believes the CFTC must therefore follow the APA's requirements when it considers both new registered entity rules and changes to existing rules. Adding this level of transparency to the Commission's review process will further enhance public confidence in our markets.

In some cases, the power to self-certify a rule change may be misread to override other powers and policies under the Act, especially when changes are made that affect trading in contracts with considerable open interest. Those changes have real financial consequences and should be subject to prior Commission approval. For years, the Commission has reviewed DCM emergency orders—applied by definition to trading in contracts with open interest—for many public policy reasons. Allowing the DCM's self-certification powers to circumvent these emergency procedures would seem to be counter-productive. This is another area we wish to discuss with the new leadership at the Commission and the DCMs themselves to see if we can reach agreement on a workable resolution.

Competition

Promoting fair competition should be the goal of any sound regulatory program. Our strong support for the CFMA in 2000 was based in substantial part on our belief that competition, rather than a prescriptive regulatory structure that established 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 SROs would compete among themselves and with the existing exchanges for customer business based on products, quality of execution and cost.

The CFMA has sparked innovation and more new exchange applicants. But, except in the energy area, the direct product competition the CFMA had envisioned has not materialized. This is disappointing. 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. Competition also is the best system yet devised for serving the interests of our customers. That should be the touchstone of our competitive goals.

Promoting competition and innovation are the twin reasons FIA urges this Subcommittee to reject calls to eliminate the Exempt Commercial Market category in Section 2(h) of the CEA. The ECM category has stimulated most of the innovation in trading and clearing under the CFMA. ECMs are electronic trading markets for principal-to-principal trading in non-agricultural, non-financial commodities. While some ECM trades are cleared, they are not intermediated (brokered) in the traditional sense. My member firms are largely in the intermediation business and their bottom line is not necessarily well-served by non-intermediated trading. Nonetheless, FIA still supports retention of the ECM category because it serves as an incubator for the successful trading platforms of tomorrow. Entrepreneurs and other challengers of established exchanges should be able to choose how they want to begin their business and what level of regulation is compatible short term and long term with their business objectives. If you cut ECMs out of the CFMA, you cut out the competitive, innovative heart of the CFMA.

With the merger of the Chicago Mercantile Exchange and Chicago Board of Trade, some might argue that the futures industry has moved more toward concentration than competition. If that is true, FIA believes it would be very unfortunate. We know the new CME Group believes it faces real competition every day and we trust their apparent domination today will not stop them from innovating tomorrow.

FIA is still hopeful that the CFMA formula of low regulatory barriers to entry through principles-based oversight will stimulate new trading platforms to compete with the traditional exchanges. Technological advances and globalization may inspire competition in areas we can't even predict today. After all, in 2000 who would have predicted that the "winner takes all" natural monopoly model for futures trading would be so discredited in the energy area today where the New York Mercantile Exchange and IntercontinentalExchange leadership match wits daily to try to gain a market advantage. Perhaps 8 years from now or less, this form of vigorous direct competition will expand to other commodity areas beyond energy.

If not, it may be appropriate to reconsider various market structure issues. Other competitive models exist in other financial trading markets, like the securities options world, which might have elements that could be adapted to the futures markets. For example, I have been asked by my members why the Options Clearing Corporation has been able to reduce its clearing fees in light of extraordinary trading volume, while the futures clearing fees have not experienced a similar reduction despite record futures volume. Is this difference because of administrative efficiencies, technology, ownership structure, governance or some other factor? At this point, I have to admit, I don't know the answer.

What I do know is that competition and market structure are critical issues for customer service. We would urge this Subcommittee to ask the CFTC to study the state of competition among centralized trading platforms and clearing entities for derivatives products with an eye toward making sure the existing futures market structure is the best for serving our customers.

Energy

Everyone agrees that the price of energy is a critical element of our national economy. For decades, energy futures have served our national interest by providing a means for efficiently managing and reliably discovering energy prices. The Commission should take pride in its effective oversight and stewardship of these markets.

In recent years, energy markets have experienced considerable innovation and increasing competition, largely as a result of the CFMA. The CFMA has made it possible for new markets to compete with established exchanges. That competition has caused traditional exchanges to modernize through electronic trading or at least increase their pace of modernization. The CFMA has also encouraged innovative thinking by established exchanges and new trading platforms. The result is that those trying to manage energy price risks and those willing to assume those risks now have more choices than ever before. Indeed, one of the most popular recent innovations in energy—the ability to submit certain private bilateral energy transactions to regulated clearing entities—flowed directly from the CFMA's provisions. The importance of this innovation cannot be overstated. Those bilateral, but cleared, transactions on the New York Mercantile Exchange's ClearPort facility now comprise approximately 20–25% of that exchange's monthly volume.

In our view, the CFMA has sparked these positive developments without compromising the public interest, including the vital interest in preventing price manipulation. The Commission continues to deploy a wealth of market surveillance techniques and an arsenal of enforcement weapons in its pursuit of what Chairman Lukken has labeled the agency's zero tolerance of price manipulation. These Commission tools include large trader reports, special calls, position limits, price manipulation enforcement actions and even sweeping, perhaps unprecedented market emergency powers. Clearly, the Commodity Exchange Act and the Commission's regulatory apparatus continue to target price manipulation as public enemy #1.

FIA agrees with this emphasis. Price manipulation should be prevented whenever possible and never tolerated. The best defense against price manipulation is effective CFTC market surveillance based on all relevant large trader information. The Commission's recent proposal to confirm under its special call authority that large traders must maintain books and records for related non-reportable transactions is fully consistent with this philosophy. The Commission's proposal would even include trades on foreign boards of trade within this special call authority so that the Commission could obtain access to surveillance data from a large futures trader on both a U.S. exchange and a foreign exchange in the same commodity. The Commission's proposal illustrates that the agency's existing authority is substantial and adaptable to current market needs and conditions.

Some have questioned how well the existing anti-manipulation defenses work when more than one energy derivative market exists. In FIA's view, multiple trading facilities, like NYMEX and the IntercontinentalExchange today in energy, only enhance the need for vigorous CFTC oversight. When two markets are largely competing directly, it is most important that CFTC market surveillance have ready access to all relevant large trader information.

If we are to have same commodity competition among trading facilities, as the CFMA contemplated and FIA has espoused, then the Commission must conduct this kind of multiple market surveillance. This is perfectly consistent with the statute. In the CFMA itself, Congress signaled that promoting multiple trading platforms in energy derivatives did not mean that price manipulation prevention should be shortchanged. Instead, Congress made clear in the statute that for any energy or other "exempt commodity" transactions conducted on a "many to many" trading facility—whether that facility was a DCM, DTEF, or ECM—the Commission was empowered to enforce the statute's prohibition against price manipulation.

In contrast, Congress did not extend manipulation protections to bilateral, non-trading facility transactions in excluded or exempt commodities. FIA agrees with that congressional judgment, embodied in sections 2(d) and 2(g) of the CEA. Price manipulation is of little concern in one-off, non-standardized transactions between two eligible contract participants where the price affects the individual transaction, not a wider market. But where the pricing of trades would affect the interests of other market participants, or even others that base commercial transactions on futures market prices, the CFTC has an interest in preventing futures price manipulation. In those circumstances, the CFTC must be the cop on the beat.

The Commission's traditional role as the exclusive regulator of futures transactions and markets actually compels this kind of comprehensive and vigilant multi-market surveillance approach. Multiple markets combined with multiple regulators would be a recipe for disaster. The slow growth of single stock futures in the U.S., relative to other countries, indicates that shared jurisdiction regimes may at least inhibit the development of viable trading markets.

The Commission has in the past made its preeminence in U.S. futures market surveillance known to its sister regulatory agencies overseas. If a DCM and a foreign board of trade list for trading essentially the same contract, the Commission understandably coordinates its surveillance activities with foreign regulators. The Commission's experience with the Financial Services Authority and ICE Futures Europe illustrates how well this kind of cooperative information sharing approach can work in practice. The Commission is to be commended for establishing the necessary arrangements without overburdening market participants or sacrificing its legitimate surveillance needs.

FIA recognizes that Congress is not clairvoyant and that market conditions change, especially in a world driven by changes in technology that come at us faster every day. We know the Commission will take whatever steps it determines to be appropriate to update its regulatory approaches consistent with its statutory authority. FIA understands it is possible that the Commission may decide that it lacks some needed authority in some areas and may therefore want to recommend to this Subcommittee some changes in those areas. Perhaps, as one major ECM has observed in a Congressional hearing, limited changes might be called for in the ECM area for some commodities in some circumstances where multiple markets exist. But the tests for any of these changes should be: are they essential for the performance of the CFTC's market surveillance function and are they the least intrusive means for achieving the required outcome?

FIA does not believe that any statutory change should be a basis for leveling the so-called competitive playing field in energy or any other area. Congress has appropriately allocated regulatory oversight in the CEA based on differences in market participants, commodities traded, means of trading, intermediation and even impact on cash markets. FIA would not support any fundamental change to that regulatory alignment.

Retail OTC Foreign Currency Transactions.

As the Subcommittee will recall, the CFMA amended the so-called Treasury Amendment based on a two-fold recommendation of the President's Working Group on Financial Markets. First, the CFTC would continue to have no jurisdiction over OTC foreign currency futures and options transactions effected between eligible contract participants, as defined in the Act (large, financially-sophisticated, well-capitalized, or otherwise regulated market participants). Second, retail customers could effect OTC foreign currency futures and options transactions only if the customer's counterparty for those transactions 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 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.)

In the past 7 years, many unregistered and unregulated entities have engaged in widespread sales practice and financial fraud in connection with off-exchange foreign currency transactions with retail customers. Some of 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.

Some years ago the 7th Circuit's decision in *CFTC* v. *Zelener* concerning the legal tests for proving that a transaction is a futures contract called into question the Commission's jurisdiction. In that case, the court rejected the multi-factor futures definitional 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. Some claim this decision has created enforcement problems for the Commission.

As FIA told this Subcommittee in 2005, we agree the CFMA's approach to granting the Commission enforcement jurisdiction over retail fraud in foreign currency (FX) transactions was imperfect. That is why we were pleased when the PWG came forwarded with a targeted solution to this problem in 2005, and we endorsed the PWG's proposal. While we have some technical suggestions for that legislative proposal, FIA continues to support the PWG's approach. It would expand the CFTC's enforcement powers to apply its antifraud authority to the offer and sale of *Zelener*-like FX contracts. And it would require those that solicit customer business in the retail FX area to be registered.

FIA does not believe that further regulatory authority is needed at this time, but we understand that National Futures Association may offer some further refinements to shore up the PWG's language in some respects. We look forward to reviewing the NFA proposals in the retail FX area.

Conclusion

Our last point is a familiar one and a critical one. Price manipulation is public enemy #1 because it affects both market participants and the public at large. Price manipulation can have a serious ripple effect in our economy and can hurt many innocent bystanders. That is why continued CFTC vigilance is so important.

It is also why Commission regulation benefits not just market participants, but just as profoundly non-market participants. For that reason, FIA continues to be vehemently opposed to funding the CFTC through a transaction tax. In our view, all taxpayers benefit from CFTC market oversight. Therefore all taxpayers should pay for it. If the CFTC needs additional resources, the Administration should request and Congress should appropriate the necessary funds. But imposing an arbitrary and egregious tax that would be borne most by those that provide the liquidity that allows futures markets to serve so many public interests is a bad idea whose time should never come.

Thank you for holding this hearing and for considering our views. I would be happy to answer any questions you might have.

Mr. ETHERIDGE. Thank you, sir. Ms. Becks.

STATEMENT OF THERESA D. BECKS, MEMBER, MANAGED FUNDS ASSOCIATION; PRESIDENT AND CEO, CAMPBELL AND COMPANY, INC., TOWSON, MD

Ms. BECKS. Chairman Etheridge and Members of the Subcommittee, thank you for inviting me to testify today. My name is Terri Becks. I am appearing today in my capacity as a Member of the Managed Funds Association, the MFA, of which I recently served on the Board of Directors. I am involved in MFA through my role as President and CEO of Campbell and Company, Inc. We are one of the oldest and largest futures trading advisers in the world.

A little bit about MFA. It is the primary trade association representing professionals who specialize in the management of alternative investments. MFA members offer investment products that are not generally correlated to the performance of traditional stock and bond investments. These alternative investments help public investors, as well as more sophisticated investors diversify their portfolio. By taking speculative positions in alternative markets, these investments serve the markets as a whole by adding liquidity and acting as shock absorbers.

MFA members have no competitive agenda. We simply want access to efficient, transparent, fair and financially secure markets. In that sense, the interests of MFA members have been well-served by the excellent work the CFTC and its staff have performed for many years. In order to continue to fulfill its unique role and important responsibilities, the CFTC must have sufficient funding to support a full and competent staff. Accordingly, MFA strongly supports reauthorizing the CFTC and providing the CFTC with additional resources.

MFA members' interests have also been very well served by the Commodity Futures Modernization Act, landmark legislation that was authorized by this Subcommittee. MFA does not see a need for major changes to the CFMA. No case has been made to turn back the clock by re-regulating Exempt Commercial Markets that have served as an incubator for derivatives trading innovation. Although where the markets are linked, the CFTC should have authority to obtain large trader reports. We do agree with that suggested change.

When creating the CFTC in 1974, Congress entrusted it with exclusive jurisdiction over futures markets to ensure that no other agency would look over its shoulder and second guess its regulatory judgments. If jurisdiction is shared either at the Federal or state level, market participants will find themselves facing, at worse, conflicting, and at best, duplicative government regulations. For this reason, MFA encourages the CFTC to assert vigorously its exclusive jurisdiction as Congress intended and the courts have interpreted. MFA members are acutely aware of the unwarranted cost and burden multiple regulators impose.

One of the best examples of how multiple sources of regulation squelch innovation is the public commodity pool business. I am very familiar with that, as we sponsor our own public funds. Public commodity pools are the best vehicle through which retail investors can access the futures markets. These pools are managed professionally, allow investors to diversify their risks and provide an affordable futures-based product with a limited liability structure. Besides the CFTC, the SEC, the NFA, FINRA and each of the 50 states all regulate commodity pools. Multiple regulators impose a great cost upon commodity pools that is often not warranted by a cost benefited analysis.

In addition to that, in all honesty, I find, in dealing with all the various regulators, there is a little bit of teaching that we have to do with those that are not familiar with things like the CFTC is on our specific investment vehicles. Another thing, for example, commodity pools are subject to the same record maintenance and Sarbanes-Oxley reporting requirements as Fortune 500 companies. SOX was not designed with passive investment pools in mind and its application to commodity pools is unwarranted. MFA recommends that public commodity pools be treated like investment companies for purposes of SOX under the same applicable exemption.

Another example of over-regulation is FINRA RULE 2810. Prior to approving a public offering of commodity pools, FINRA calculates the underwriting compensation. It imposes a 10 percent cap on such compensation. Previously, FINRA exempted from this calculation the payment trails for public commodity pools. That exemption reflected the additional service an associated person would provide to a pool investor due to the esoteric nature of commodity pools and market. In 2004 FINRA ended the exemption for pool trail commissions. FINRA believed that its action would not stop the offering of commodity pools to the public.

However, since its action, we have seen fewer public commodity pools offered. As a practical matter, FINRA's actions have forced new commodity pools that would have been offered publicly to become private or not offered at all. In effect FINRA's actions deny public investors access to an attractive diversification in their investment alternatives. MFA believes that the trail commission experience and the duplicative filing requirements illustrate well the dangers of multiple regulators and the costs it imposes on market innovation. In your deliberations, MFA asks the Subcommittee to take these concerns into account and to consider any appropriate measures to help revive the public commodity pool business.

Again, thank you for this opportunity to appear today and I would be happy to answer any questions that you have.

[The prepared statement of Ms. Becks follows:]

PREPARED STATEMENT OF THERESA D. BECKS, MEMBER, MANAGED FUNDS ASSOCIATION; PRESIDENT AND CEO, CAMPBELL AND COMPANY, INC., TOWSON, MD

Chairman Etheridge and Members of this Subcommittee, thank you for inviting me to testify today. My name is Terri Becks. I am appearing today in my capacity as a Member of the Managed Funds Association (the "MFA"), for which I recently served on the Board of Directors. I am involved in MFA through my role as President and CEO of Campbell & Company, Inc.—one of the oldest and largest futures trading advisors in the world.

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 1,400 members, including the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over $1.67 trillion invested in absolute return strategies. Many MFA members are registered with the Commodity Futures Trading Commission (the "CFTC") as commodity trading advisors ("CTAs") and commodity pool operators ("CPOs").

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. Funds sponsored by MFA 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 generally correlated to the performance of traditional stock and bond investments. 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. These investments also help them meet their future funding obligations and other investment objectives. MFA 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 remain on the sidelines. Fund trading activity also provides markets with price information, which translates into pricing efficiencies, and assists in identifying pricing inefficiencies or trouble spots in markets. Moreover, these funds utilize state-of-the-art trading and risk management techniques that foster financial innovation and risk sophistication among market participants.

As major customers of futures exchanges and futures commission merchants ("FCMs") as well as purchasers of other futures industry services, many of MFA's members directly benefit from the provisions of the Commodity Exchange Act (the "CEA" or the "Act") and in particular, the reforms brought about by the Commodity Futures Modernization Act of 2000 (the "CFMA"). The CFTC's oversight of the U.S. 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 (the "NFA")—the industry's self-regulatory organization. The CFTC and the NFA oversee the business activities of CPOs and CTAs through registration, disclosure, anti-fraud, recordkeeping and reporting requirements, and periodic audits. Each of the futures exchanges also monitors trading activities of MFA members in their respective markets.

Many of MFA's members are subject to regulation under other Federal statutes 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 Exchange Act of 1934, which requires the filing of certain publicly-available reports as well as to the individual securities laws of each of the 50 states. Many of MFA's members are also subject to the anti-money laundering requirements of the USA PATRIOT Act of 2001. Unlike investment companies, many MFA members are also subject to all of the records maintenance requirements of the Sarbanes-Oxley Act of 2002 ("SOX").

MFA has a strong interest in the issues you are discussing today. MFA members trade on exchange and off exchange. We are neutral in any competitive battles that pit traditional exchanges against new trading platforms, or multi-lateral systems against bilateral dealer operations. Our members simply want access to efficient, transparent, fair and financially secure markets. In that sense, the interests of MFA members have been well served by the excellent work the CFTC and its staff have performed for many years.

MFA members' interests have also been well served by the CFMA, landmark legislation that was authored in this Subcommittee. In that statute, Congress adopted a cascading regulatory approach with different levels of oversight assigned to trading in different categories of commodities, market participants and order execution facilities. The CFTC has been masterful in applying these new statutory provisions to allow new market forces to compete with traditional exchanges in a host of areas, especially in energy. MFA members have benefited from these CFMA-inspired innovations. Since the CFMA was passed, 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 to our industry and the statutory framework under which it operates. MFA strongly supports reauthorizing the CFTC.

Importance of the CFTC and the CFMA

In order to continue effectively fulfilling the CFTC's unique role and important responsibilities, the CFTC must have sufficient funding to support a full, competent staff. Accordingly, MFA supports the CFTC's requests for additional resources.

MFA does not see a need for major changes to the CFMA. No case has been made to turn back the clock by re-regulating new trading platforms, known as Exempt Commercial Markets ("ECMs"), that have served an incubator function for derivatives trading innovation. MFA understands that the CFTC's website has listed 19 ECMs that have been created since the CFMA was passed. Those markets operate as principals only, electronic trading venues for sophisticated well-capitalized market participants. MFA believes it is both appropriate and important to cultivate those innovative enterprises.

Exclusive Jurisdiction and the Avoidance of Duplicative Regulation

When the CFTC was created in 1974, Congress entrusted it with exclusive jurisdiction over futures markets to ensure that no other agency—whether it be the SEC, USDA or the Bureau of Mines—would look over its shoulder and second-guess its regulatory judgments. Congress wanted an agency expert in futures markets to determine whether a threat of manipulation existed or some other major market disturbance caused futures market prices not to reflect accurately the forces of supply and demand. In short, Congress wanted the CFTC to be able to take appropriate action if it sniffed the possibility of manipulation in the air.

Congress vested extraordinary emergency powers in the CFTC to address any such threat, powers the CFTC once called the linchpin of the Act. The CFTC has correctly used those powers very sparingly, but their existence serves a very important purpose. Exchanges and market participants alike know that the CFTC alone is ready to act when in its informed, expert judgment, action is warranted. That power can not work if it is shared with other regulatory bodies, either at the Federal level or the state level; nor can more than one agency police price manipulation in futures markets themselves.

Otherwise exchanges, intermediaries, advisors, funds and other market participants will find themselves facing at worst conflicting, and at best, duplicative, government regulation, the very ills Congress sought to cure with exclusive jurisdiction. Multiple regulators sharing concurrent jurisdiction will not strengthen regulation. They will just water down regulation at a considerable cost to market participants.

MFA encourages the CFTC to assert vigorously its exclusive jurisdiction as Congress intended and the courts have interpreted.

Public Offerings of Commodity Pools

One of the best examples of how multiple sources of regulation squelch innovation is the public commodity pool business.

Public commodity pools are the best vehicle through which retail investors can access the futures markets because these funds are offered through a full risk disclosure regime and provide an affordable futures-based product with a limited liability structure. Public commodity funds are one of the only alternative investment products available to public investors to diversify a traditional stock and bond portfolio. Public commodity pools are managed professionally and typically offer liquidity monthly—much more frequently than many other forms of alternative investments.

The CFTC, of course, exercises regulatory jurisdiction over commodity pools. But its jurisdiction is far from exclusive. Commodity pools are also regulated by the SEC, NFA, the Financial Industry Regulatory Authority [1] (the "FINRA") as well as state blue sky regulators.

MFA believes that multiple sources of regulation have contributed directly to severe contraction of the public commodity pool offering market. Why? Regulation and over-regulation bear at least some of the responsibility. For example, unlike investment companies, commodity pools are subject to the same records maintenance and SOX reporting requirements as Fortune 500 companies. It is worth noting that public commodity pools have been subject to substantively similar oaths, recordkeeping and reporting requirements for more than 2 decades prior to the enactment of SOX. Unlike these requirements which were tailored specifically for public commodity pools, SOX applies broadly to operating companies. The unnecessarily complicated and duplicative requirements of SOX impose real costs to those that may want to offer new public commodity pools as variations exist between the SOX requirements and those requirements tailored for public commodity pools. MFA supports and encourages the treatment of publicly offered commodity pools like investment companies for purposes of SOX, providing exemptive relief that would promote competition.

Moreover, public commodity pools are subject to both registration with and regulation by each of the 50 states which are often referred to as Blue Sky laws. Blue Sky registration and regulation impose a great cost that is often not warranted by a cost-benefit analysis. Blue Sky laws from one state sometimes contradict those from another state. Certain Blue Sky laws even conflict with Federal regulation. Blue Sky compliance therefore is an extra cost imposed on commodity pool offerings.

FINRA RULE 2810 (also commonly referred to as "Direct Participation Programs" or "DPP Rule") is another example. It requires that, prior to the public offering of commodity pool securities, information must be filed with FINRA's Corporate Financing Department, who must then provide a "no objections" opinion. Before

[1] The Financial Industry Regulatory Authority is a self-regulatory organization created in July 2007 through the consolidation of the National Association of Securities Dealers and the member regulation, enforcement and arbitration functions of the New York Stock Exchange.

issuing this opinion, FINRA takes into account the proposed terms and arrangements of the DPP offering, including the level of underwriting compensation which may not exceed 10 percent of the gross proceeds of the offering.

Prior to October 12, 2004, FINRA staff excluded the payment of trail commissions for commodity pool direct participation programs from the underwriting compensation limits of the DPP Rule if: (a) the member was registered as a FCM with the CFTC; (b) the associated person receiving the trail commissions passed one of two exams (the National Commodity Futures Examination ("Series 3") or Futures Managed Funds Examination ("Series 31")); and (c) the associated person receiving the trail commissions provided ongoing investor relations services to its investors. Trail commissions for public commodity pools were not included within the underwriting compensation because this money was seen as a service fee the investor paid to a qualified associated person in exchange for ongoing advice. This policy of excluding public commodity pools from the DPP Rule was based on the continuing and regular service the associated person would provide to keep the investor informed about the status of the investment due to the esoteric and complex nature of commodity pools and markets. In addition to encouraging associated persons to obtain Series 3 or Series 31 certification, this treatment provided an incentive for associated persons to recommend public commodity pools to investors where appropriate as the trail commissions compensated him or her for the additional servicing required due in part to the nature of regular and frequent redemption opportunities.

The trail commission is the portion of futures brokerage fee or commission charged by the FCM to the pool which is allocated to the associated person. FINRA lacks jurisdiction over the level of futures brokerage commissions and cannot regulate either the brokerage fee as a whole or its internal allocation within the brokerage firm. In any event, from the perspective of many public investors, trail commissions would not increase their cost. If trail commissions are unavailable, the FCM will simply charge the same brokerage commission to the pool, without allocating any portion of it to the associated person who sold the investment.

In July 2004, FINRA acted on its belief that notwithstanding the limitation of including trail commissions as underwriting compensation, firms and registered representatives would continue to offer and recommend commodity pool DPPs. FINRA believed revocation of the trail commission exemption would benefit investors in commodity pool DPPs by limiting compensation to the same amounts that already applied to all other DPP investments. Thus, effective October 12, 2004, FINRA began including trail commissions in calculating whether the level of underwriting compensation exceeds the 10% limitation in the DPP Rule.

Since FINRA began including trail commissions for commodity pools as underwriting compensation, fewer new public commodity pools have been offered. It seems clear that—contrary to FINRA's belief—firms and registered representatives have drastically reduced offering public commodity pools and have fewer public commodity pools to recommend where such products meet investors' financial status and investment objectives. As a practical matter, FINRA's actions have forced new commodity pools that would have been public offerings to become private offerings or not be offered at all. Because commodity pools are not available to many public investors when offered privately, many public investors are denied access to an attractive diversification investment alternative. In contrast to more sophisticated investors, the best diversification alternative available to these public investors is to invest directly in the futures market—a far riskier undertaking than public commodity pools. Ironically, public customers also pay full brokerage commissions to FCMs for such direct participation in a futures trading account, not the lower rates often charged commodity funds.

MFA makes these observations both as a reminder of the perils of over-regulation through multiple regulation and to request the Subcommittee's consideration of appropriate measures that could be taken to revive the public commodity pool business.

Again, thank you for this opportunity to appear today. I would be happy to answer any questions you may have.

Mr. ETHERIDGE. Thank you, ma'am. Mr. Brodsky.

STATEMENT OF WILLIAM J. BRODSKY, CHAIRMAN AND CEO, CHICAGO BOARD OPTIONS EXCHANGE, CHICAGO, IL; ON BEHALF OF U.S. OPTIONS EXCHANGE COALITION

Mr. BRODSKY. Thank you, Chairman Etheridge and Ranking Member Moran. I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange. Prior to my service at the Chicago Board Options Exchange, I was for, almost 12 years, CEO of the Chicago Mercantile Exchange, where I was obviously involved on the futures side of the business. I am also currently Chairman of the International Option Market Association, which represents 50 options exchanges around the world.

I appear today, however, on behalf of the CBOE and the five other United States securities options markets, which include the American Stock Exchange, the Boston Options Exchange, the International Securities Exchange, the New York Stock Exchange and the Philadelphia Stock Exchange, as well as our clearinghouse, the Options Clearing Corporation, and together, we comprise the U.S. Options Exchange Coalition.

And just by way of perspective, the U.S. options industry provides an increasingly important role in our economy. Last year the exchange listed option business grew at a 35 percent rate, which is higher than the stock business, the equity business, at 13 percent, and the futures business at 26 percent. In addition, the volume on all the U.S. options exchanges is approximately the same as all the futures exchanges, so it keeps in perspective the size of our community, as well.

In brief, we support reauthorization of the CFTC. We believe the CFTC has done a very good job. But we also believe that it is high time for a macro review of regulation of financial derivatives that recognize the overlapping jurisdiction in financial derivatives. And I would point out the fact that the Treasury is now undertaking a study which will include some of these issues.

In addition, I would like to commend the Committee not only on CFMA of several years ago, but also your support 2 years ago of the vital issues on portfolio margining that helped spur the SEC to act on implementing a broad base portfolio margining pilot that unequivocally has made our securities markets more competitive. However, there are still many issues that Congress can address related to portfolio margining and other important topics. As I sit here today, it is clear that despite the best intentions of all the parties, the system of separating the regulation of futures and securities is broken and needs to be fixed.

This creates regulatory inefficiencies, hampers U.S. competitiveness and impedes innovation. No other country in the developed derivative markets applies such a system of two different government agencies regulating equivalent financial products. While a merger of the CFTC and the SEC into a combined agency or the creation of a newer agency would address these issues, the mechanics and the politics of such a merger would be a long time goal. In the meantime, there are concrete steps that can be taken now to address the effects of split jurisdiction.

First, Congress could end the current system of split Congressional oversight of the two agencies. Having both the SEC and the CFTC subject to the jurisdiction of a single Congressional Committee would help ensure the consistent oversight of financial regulators. Second, when jurisdictional disputes do arise between the SEC and the CFTC, there is currently no mechanism to resolve them other than a dialogue between the two agencies or litigation. Perhaps, if the SEC and the CFTC, despite their best intentions, find themselves at an impasse, they should seek the input of other members of the Presidential Working Group, specifically, the Treasury and the Fed, to resolve these issues promptly.

But even assuming these steps are taken, the current regulatory system is impeding U.S. global competitiveness and innovation in several ways. Our major areas of concern are the following: One is new product approval process and the lack of legal certainty and the other is portfolio margining. The U.S.'s bifurcated regulatory system presents significant hurdles that must be overcome in connection with new product approval. When questions arise as to whether a particular new product is more properly a security or a future, the result can be an interminable delay in bringing that product to market while the two agencies try to decide who has the jurisdiction over the product.

Two recent examples are illustrative. The first involves options on exchange traded funds that invest and hold gold. In June of 2005, the CBOE filed a proposal with the SEC to trade options on gold ETFs. The gold ETFs themselves have continued to trade as securities on securities exchanges. CBOE's related option proposal has not advanced because the SEC and the CFTC are still trying to agree, more than 2 years later, on which agency should regulate this option product.

Another example, both the Chicago Mercantile Exchange and the CBOE began to trade credit default derivatives this year, but not before it took the SEC and the CFTC approximately 9 months to determine how to allocate the jurisdiction of these two products between the two agencies and after a similar product began trading overseas. The bifurcated system also subjects our clearing agency, the Option Clearing Corp, to the jurisdiction of both the SEC and the CFTC every time it proposes to clear a new product. This process is time consuming and delays product innovation and effectively gives the CFTC a veto over the introduction of new securities products.

There must be a means to ensure that the proposed new products that raise jurisdictional issues may be introduced to the market more promptly and efficiently. Perhaps other members of the Presidential Working Group could broker the jurisdictional issue in the case of an impasse. This could also be a recognition by the SEC and the CFTC of the circumstances such as where the underlying instrument is either a security or a future in which jurisdiction should not be a dispute.

The second example involves portfolio margining. While earlier this year the potential availability of portfolio margining became greatly expanded, legal impediments to putting those futures positions in securities customers' accounts for portfolio margining still exist. Two important changes must occur in order to permit investors to avail themselves of the full potential of portfolio margining. First, Congress needs to amend the Securities Investor Protection Act so that futures positions in a customer's portfolio margining account are protected by SIPA insurance. Without a legislative change to SIPA, full evolution to a state-of-the-art portfolio margining system for customers may never occur in the U.S.

Second, the securities industry and the futures industry have advocated different approaches to the issue of portfolio margining.

Under the security industry's "one pot" approach, all securities and futures positions are maintained in a single portfolio margins securities account for the purpose of maximizing the utility of margin collateral in the account. Under the futures industry "two pot" approach, a futures account holds the futures position and the securities account holds the securities position for purposes of maintaining margin collateral. For a host of reasons, the Coalition believes that the "one pot" approach is the most efficient means of portfolio margining.

To enable customers to use a single securities account for portfolio margining purposes, however, the CFTC will have to provide exemptive relief under the Commodity Exchange Act, yet as another example of the jurisdictional divide between the SEC and the CFTC, the two agencies continue to disagree on the most appropriate approach to implementing portfolio margining. If the agencies are unable to agree on the steps necessary to fully implement portfolio margining, as its most efficient "one pot" level outlined above, Congress or the Presidential Working Group should step in to help facilitate a full-course margining for all securities products and their related futures.

The Coalition and I stand ready to work with the Committee and its staff as they consider these important issues. I would be happy to answer any questions you may have and I would request that my full statement be entered into the record. Thank you very much.

[The prepared statement of Mr. Brodsky follows:]

PREPARED STATEMENT OF WILLIAM J. BRODSKY, CHAIRMAN AND CEO, CHICAGO BOARD OPTIONS EXCHANGE, CHICAGO, IL; ON BEHALF OF U.S. OPTIONS EXCHANGE COALITION

Mr. Chairman and Members of the Subcommittee, I am William J. Brodsky, Chairman and Chief Executive Officer of the Chicago Board Options Exchange ("CBOE"). I appear today on behalf of the CBOE and the five other United States options markets: the American Stock Exchange, the Boston Options Exchange, the International Securities Exchange, NYSE–ARCA, the Philadelphia Stock Exchange, and our clearinghouse, The Options Clearing Corporation ("OCC"). Together, we comprise the U.S. Options Exchange Coalition ("Coalition"). Our markets trade all the exchange-traded security options in the U.S., such as options on individual stocks, stock indexes, exchange-traded funds, debt securities, securities volatility, and foreign currency. These markets provide the major hedging instruments for the U.S. stock market.

Chairman Etheridge, Ranking Member Moran and Members of the Subcommittee, I would first like to thank you for allowing the U.S. Options Exchange Coalition to provide its views on reauthorization of the Commodity Exchange Act ("CEA"). The U.S. options industry provides an increasingly important role in our economy. Last year exchange-listed options experienced a 35% growth rate, higher than both stock (13%) and futures (26%) trading. Additionally, the number of U.S. listed options contracts traded in 2006 approached the number of contracts traded in all U.S. futures markets combined. Through August 2007, a record 1.82 billion option contracts changed hands in the U.S. options market, a 37.5% increase from the same year-ago period, and daily trading volume has averaged 10.8 million contracts up from 7.9 million contracts at the end of August 2006, with a record 23.7 million options contracts being traded on August 16, 2007.

This unprecedented growth could not have been possible without effective Congressional support and oversight of the U.S. commodity futures and securities markets and their regulators. In particular, I would like to commend this Subcommittee's exemplary work in the 109th Congress on reauthorization of the Commodity Exchange Act. While the reauthorization process was not completed, your support 2 years ago on vital issues such as portfolio margining helped to spur the U.S. Securities and Exchange Commission ("SEC") to act on implementing a broad-based portfolio margining pilot program that will unequivocally make our securities markets more competitive. However, there are still issues Congress can address related to portfolio margining and other important topics, which leads me to comment at today's hearing.

Above all else, let me stress that it is not our intention to impede, in any way, the reauthorization of the CEA. Rather, while you consider the various issues surrounding reauthorization, we urge you to consider our proposals, which we believe will benefit all U.S. financial markets and U.S. investors. We believe that actions can be taken now that will help to finally resolve issues that have persisted for over 30 years.

Since the enactment in 1974 of amendments to the CEA, which gave the CFTC jurisdiction over all futures but also provided that the jurisdiction of the SEC was not otherwise superseded or limited, there have been conflicts between the two agencies as to their respective jurisdiction over novel financial instruments that have elements of both securities and futures or commodity contracts. In an attempt to resolve those conflicts, the CFTC and SEC agreed, through what became known as the Shad-Johnson Accord, to specify which financial instruments fell within each agency's jurisdiction. In 1982 and 1983, Congress codified the Shad-Johnson Accord through amendments to the CEA and the Federal securities laws.[1] Although that legislation helped to provide legal certainty regarding each agency's jurisdiction in certain situations, it did not put an end to the jurisdictional disputes between the two agencies in all circumstances. Congress took a step toward this goal when it enacted the Commodity Futures Modernization Act of 2000 ("CFMA").[2] The CFMA established a delicate competitive balance between security futures (i.e., single stock futures) and security options, but the bifurcated system of regulation between all other security-based futures and securities still exists today.

Competitive forces and the demutualization of exchanges, among other factors, have caused the jurisdictional divide between the SEC and CFTC to widen dramatically in recent years. This lack of agreement between the two agencies has recently been called a "jurisdictional balkanization" by current SEC Chairman Christopher Cox. As I sit here today, it is clear that, despite the best intentions of all parties involved, the bifurcated system of regulating futures and securities is broken and needs to be fixed. This disjointed structure adversely affects the ability of U.S. exchanges to bring new products to market and to compete. Additional measures can and should be taken to streamline the regulation of these similar investment products.

Competitive forces and the demutualization of exchanges, among other factors, have caused the jurisdictional divide between the SEC and CFTC to widen dramatically in recent years. This lack of agreement between the two agencies has recently been called a "jurisdictional balkanization" by current SEC Chairman Christopher Cox.[3] As I sit here today, it is clear that, despite the best intentions of all parties involved, the bifurcated system of regulating futures and securities is broken and needs to be fixed. This disjointed structure adversely affects the ability of U.S. exchanges to bring new products to market and to compete. Additional measures can and should be taken to streamline the regulation of these similar investment products.

In the view of the U.S. Options Exchange Coalition, competitive fairness requires that futures and comparable securities be regulated in a consistent manner. That, unfortunately, is not always the case due to the differing missions of the SEC and the CFTC. In general, the securities laws are designed to protect investors, provide full disclosure of corporate and market information, and prevent fraud, insider trading and market manipulation. By contrast, the commodities laws are designed to facilitate commercial and professional hedging and speculation and to oversee the price discovery process. These differing goals may come into conflict when applied to a particular situation in which both agencies have an interest.

A prime example of this occurred recently in connection with the highly publicized problems surrounding Sentinel Management Group, Inc. Sentinel is both an investment adviser registered with the SEC and a futures commission merchant registered with the National Futures Association. When questions arose as to the disposition of certain funds held by Sentinel on behalf of various futures commission merchants ("FCMs") and other clients, the SEC and the CFTC took very different positions. While the SEC sought to freeze the proceeds in all Sentinel accounts (which it asserted had been improperly commingled) for the ultimate benefit of in-

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[1] *See* Futures Trading Act of 1982, P.L. No. 97–444, 96 Stat. 2294 (1983); Act of Oct. 13, 1982, P.L. No. 97–303, 96 Stat. 1409.

[2] P.L. No. 106–554, 114 Stat. 2763 (2000).

[3] *See* Grant, J., "Lack of Consensus Dogs US Regulators," *Financial Times* (Aug. 26, 2007).

jured investors (including, but not limited to, the affected FCMs), the CFTC sought to ensure that the FCMs were given access to their (or their customers') funds that had been in a segregated account in order to preserve the integrity of the futures markets and prevent a potentially broader, market-wide collapse. This lack of consensus between the two agencies so exasperated the U.S. District Court judge hearing the matter that he was quoted in the hearing transcript as saying, "Why doesn't this agency of the government go over and talk to this [other] agency of the government and get your act together, for crying out loud?"[4]

The current bifurcated regulatory system, under which futures and securities are regulated differently, has led to persistent negative consequences for our markets. The disjointed structure creates regulatory inefficiencies, hampers competitiveness, and impedes innovation. Because of the differing views of the two agencies, questions of jurisdiction with respect to new products—that is, is a new product a security or a future?—are rarely resolved quickly. Split jurisdiction and different governing statutes also lead to legal uncertainties, since a novel aspect of a new securities derivative product could cause the CFTC to claim that the product has elements of a futures contract, and a novel aspect of a new futures product could cause the SEC to claim that the product is a security. No other country with developed derivative markets applies such a system of two different government agencies regulating equivalent financial products.

While a merger of the CFTC and the SEC, or the creation of one new agency that regulates both futures and securities, would address these issues, the mechanics of effectuating such a merger or creating a new agency make it a long-term goal. In the meantime, there are concrete steps that can be taken now to help bridge the sometimes wide divide between the two agencies and streamline the regulatory process. The Coalition believes that taking these actions will help to even out the competitive landscape, both domestically and between U.S. and foreign competitors, as well as provide for a more rapid way of resolving inter-agency disputes. As it considers the issues surrounding reauthorization of the CFTC, the Coalition strongly urges Congress to take these recommendations into consideration.

First, rather than take the laborious step of merging the agencies, Congress could more easily end the current system of bifurcated congressional oversight of the two agencies. The various committees with jurisdiction over the CFTC and the SEC all have legitimate interests in, and concerns about, the operation of the U.S. financial markets, but sometimes the interests of one Committee may conflict or compete with those of another. Having both the SEC and the CFTC subject to the jurisdiction of a single congressional oversight Committee would go a long way to ensure consistent oversight of financial regulators. A single, unified Committee structure not only would decrease the likelihood of potentially contradictory direction, but also would enable Congress to address issues arising with these financial products more quickly and comprehensively.

Second, when jurisdictional disputes do arise, there is currently no mechanism in place to resolve them other than a dialogue between the two agencies. This can lead to long delays in the decision-making process, which hinders competitiveness to the detriment of investors and our markets. This is not intended to imply that, when disputes do arise, either agency is not putting forth a good-faith effort to resolve them. Instead, each agency earnestly believes that it is properly applying its statute when analyzing a particular jurisdictional issue. The impasses that frequently arise may be the natural result of the differing, and sometimes conflicting, philosophies of the securities laws and the commodities laws. In such a case, however, a neutral arbiter is needed.

To help the decision-making process move more rapidly, the President's Working Group on Financial Markets ("President's Working Group") could and, we respectfully submit, should take a more affirmative role in resolving jurisdictional issues and in brokering disputes between the two agencies. The members of the President's Working Group, comprised of the Secretary of the Treasury (Chairman), the Chairman of the Board of Governors of the Federal Reserve System, and the Chairmen of both the SEC and the CFTC, are well-versed in the issues presented in such jurisdictional disputes. If the SEC and CFTC, despite their best intentions, find themselves at an impasse, they could seek input from the other members of the President's Working Group to resolve the issues promptly. Prompt resolution of jurisdictional disputes is extremely important in order to be able to bring new products to market quickly so that the U.S. capital markets can maintain their global competitiveness.

Even assuming that these overarching steps are taken, the current regulatory system is failing to foster U.S. competitiveness in stocks, futures and security option

[4] *Id.*

products in several ways. Our major areas of concern today are the new product approval process and lack of legal certainty, jurisdictional issues and dual clearing agency regulation, and portfolio margining.

The Coalition believes that steps can, and must, be taken in each of these areas, either by Congress or by the affected agency, that will improve the regulatory system governing stock, futures, and security options and keep our markets competitive in the global arena.

New Products

The bifurcated regulatory system presents significant hurdles that must be overcome in connection with the new product approval process. When questions arise as to whether a particular new product is more properly a security or a future, the result can be an interminable delay in bringing that product to market while the two agencies try to decide who has jurisdiction over the product. As a result, a comparable product may begin trading overseas, while U.S. agencies are still attempting to resolve the jurisdictional issue.

Two recent examples are illustrative. The first involves options on exchange-traded funds ("ETFs") that invest in and hold gold. These ETFs are securities and were approved for listing by the SEC on the New York Stock Exchange and the American Stock Exchange in October 2004 and January 2005, respectively. Seeking to meet customer demand for an option on the gold ETFs, and assuming that an option on SEC-approved gold ETFs also would be considered a security, in June 2005, the CBOE filed a proposal with the SEC to trade options on gold ETFs. Though the gold ETFs have continued to trade as securities on securities exchanges, the related option proposal has not moved forward because the SEC and CFTC are still trying to agree, more than 2 years later, on which agency should regulate the product.[5]

Another problem area has been the introduction of new credit derivative products. Both the Chicago Mercantile Exchange and the CBOE began to trade credit default products this year, but not before it took the SEC and CFTC approximately 9 months to determine how to allocate the jurisdiction of these products between the two agencies. The compromise reached by the two agencies, however, still did not provide legal certainty as to the basis for the allocation. Meanwhile, Eurex, a European Exchange, was able to introduce a competitive product overseas within weeks of announcing its intention to do so and before CBOE and CME could obtain the requisite approvals.

There must be a means to ensure that proposed new products that raise jurisdictional issues may be introduced to the market more promptly and efficiently. Possible solutions could include the adoption of a time limit related to new product approvals and/or having the other members of the President's Working Group broker the jurisdictional issue in the case of an impasse after a certain amount of time. There also could be a recognition by the two agencies of certain circumstances—such as where it is clear that the underlying instrument is either a security or a future or a commodity option—in which jurisdiction should not be in dispute. For instance, if the SEC has already approved a new product as a security, and that security has been registered as such with the SEC, an option on that instrument should also be presumed to be a security, barring the opposite conclusion by the SEC after its review. If this presumption would have been applied to options on gold ETFs, those option products likely would have been brought to market long ago for the benefit of U.S. investors (and others) who had made this ETF a very actively-traded product.

Jurisdictional Issues and Dual Clearing Agency Regulation

The options markets' clearing agency, OCC, clears exchange-traded derivative products, and is registered with both the SEC and the CFTC. OCC clears securities options, under the jurisdiction of the SEC, security futures, jointly regulated by the SEC and CFTC, and futures, under the jurisdiction of the CFTC. OCC is the only U.S. clearing organization with the ability to clear all of these products within a single clearing organization, and this provides the opportunity for greatly enhanced efficiency in the clearing process. However, this potential efficiency is seriously diminished by the dual regulatory structure.

Because of this dual registration, OCC is subject to the jurisdiction of the CFTC, as well as that of the SEC, every time it introduces a new securities option product. Although the CFTC operates under a self-certification process by which OCC could certify that a particular new product does not fall within the jurisdiction of the

[5] It should be noted that recently, in connection with a private letter ruling, the Internal Revenue Service agreed that gold ETFs were securities, and were not simply an ownership interest in the underlying metal. *See* Private Letter Ruling 200732036 (August 10, 2007).

CEA, there are cases where there is genuine ambiguity as to where the jurisdictional line lies. In such cases, OCC has felt compelled to ask for prior approval of both agencies in order to avoid the risk of litigation after trading has begun. While this may be ultimately effective in limiting that risk, it can also lead to protracted discussions between the two agencies. This process is time consuming and can lead to compromises that distort product development by forcing product design to be driven by jurisdictional considerations instead of economic ones. The lengthy process by which credit default options were brought to the market is an example of how this process is broken. And if no agreement can be reached at all, the exchanges and OCC are forced to either abandon the product—thus effectively allowing the CFTC a veto over a product proposed to be traded under the SEC's jurisdiction—or to incur the delay and expense of seeking a judicial resolution of the dispute.

While the dual regulation of OCC may be inefficient, it does not create the jurisdictional conflicts which are inherent in a dual regulatory scheme that attempts to divide highly similar economic products between two regulatory agencies under two different statutes. If that scheme is perpetuated, then, at the very least, we need a single decision-maker who can act as a tie-breaker to bring about prompt and inexpensive resolution of any jurisdictional question. The courts are not an efficient vehicle for this purpose. As previously noted, we believe that the President's Working Group could provide a solution.

Portfolio Margining

Earlier this year, the availability of portfolio margining was greatly enhanced for securities customers, including those who trade security futures, through expansion of an existing portfolio margin pilot program approved by the SEC.[6] This expanded pilot includes equity options, security futures and individual stocks as instruments eligible for portfolio margining. The pilot enhances U.S. competitiveness by bringing the benefits of risk-based margining employed in the futures markets, and in most non-U.S. securities markets, to U.S. securities customers. The exchange rules approving this pilot also authorized the inclusion of related futures positions in securities customer portfolio margining accounts, often referred to as cross-margining. The ability to margin all related instruments in one account would allow customers to fully realize the risk management potential of these instruments in a way that is operationally efficient. However, legal impediments to putting those futures positions into a securities customer portfolio margining account exist and undercut significantly the ability of customers to fully realize the capital efficiency benefits of portfolio margining.

As discussed below, two important changes must occur in order to permit investors to avail themselves of the full potential of portfolio margining. First, Congress needs to amend the Securities Investor Protection Act of 1970's ("SIPA") current treatment of futures positions in a customer portfolio margining account. Second, the CFTC must provide exemptive relief from the CEA's requirements regarding segregation of customer funds.

SIPA is the law which governs the activities of the Securities Investor Protection Corporation (SIPC). SIPC provides insurance to securities customers to protect them from losses caused by the insolvency of their broker-dealer. SIPC insurance does not extend to futures positions, other than security futures. Under SIPA, claims of securities customers take priority over claims of general creditors. There is a possibility, under current law, that a portfolio margining customer will be treated as a general creditor with respect to the proceeds from such customer's futures positions. The possibility of uneven treatment substantially lessens the likelihood that customers would want to include related futures products in their portfolio margining securities accounts, and would disincent those customers from taking full advantage of the efficiencies created from hedging related positions in a single account. Without a legislative solution, full realization of a state-of-the-art portfolio-based margining system for customers may never occur in this country. We advocate a targeted amendment to SIPA that would extend SIPC insurance to futures positions held in a portfolio margining account under a program approved by the SEC. A copy of our legislative proposal is attached. We ask the Committee's help in addressing this issue.

Assuming that SIPC insurance coverage is extended to futures products held in a customer's securities portfolio margining account, a second step is necessary to fully implement portfolio margining. Currently, the securities industry and the fu-

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[6] *See* Exchange Act Release No. 34–54919 (Dec. 12, 2006), 71 FR 75781 (Dec. 18, 2006); File No. SR–CBOE–2006–14; and Exchange Act Release No. 34–54918 (Dec. 12, 2006), 71 FR 75790 (Dec. 18, 2006); File No. SR–NYSE–2006–13. The effective date for these rule changes was April 2, 2007.

tures industry are advocating differing approaches to the issue of portfolio margining. Under the securities industry's "one pot" approach, all securities and futures positions are maintained in a single portfolio margin securities account for purposes of maximizing the utility of margin collateral in the account. Under the futures industry's "two pot" approach, a futures account holds the futures positions and a securities account holds the securities positions for purposes of maintaining margin collateral. The Coalition believes that the "one pot," single account approach is the most efficient means of portfolio margining for customers and their brokers.[7] In order for customers to use a single securities account for portfolio margining purposes, however, CFTC action is required. Specifically, the CFTC will need to exempt futures products held in a securities portfolio margining account from the operation of Section 4d(a)(2) of the CEA. This provision requires that all funds and property (including securities held as collateral) in a customer's futures account must be segregated from all other funds and property, although it may be commingled with the property of other futures customers. Consequently, it prohibits the carrying of futures products and related customer property in a portfolio margining account regulated as a securities account and commingled with property other than the segregated funds of other futures customers. In order to facilitate cross-margining in securities accounts under the "one pot" approach, the CFTC would therefore need to promulgate a rule or issue an order exempting futures products in such accounts from the segregation requirements of CEA Section 4d(a)(2) to the extent necessary to permit them to be carried in a portfolio margin account and segregated pursuant to the SEC's customer protection rule. Once SIPC insurance is extended to futures positions held in a securities customer portfolio margining account, we intend to seek such an exemption from the CFTC.

Highlighting the jurisdictional divide between the SEC and the CFTC, the two agencies continue to disagree on the most appropriate approach to implementing portfolio margining. In mid-2006, there were plans to establish a working group to help the agencies come to a consensus on whether the "one pot" or "two pot" approach should be implemented, but that effort appears to have stalled. Even without the input from this proposed industry working group, we strongly believe that the "one pot" approach is preferable and easier to implement.[8] If the agencies are unable to agree on the steps necessary to fully implement portfolio margining at its most efficient "one pot" level as outlined above, Congress and/or the President's Working Group should step in to help facilitate full cross margining to all securities products and their related futures.

Portfolio margining is another area where a lack of action here has placed U.S. markets at a competitive disadvantage to other markets that do not distinguish between securities and futures products.

Conclusion

The U.S. Options Exchange Coalition believes that CFTC reauthorization provides an opportunity to bring needed change to the U.S regulatory landscape in order to promote the competitiveness of U.S. financial markets. Until major structural changes are made, Congress, the CFTC and the SEC should make targeted, discrete changes to the ways in which new products are approved for trading in the markets, and provide the means by which customers can fully utilize the benefits of portfolio margining. Taking these steps will help our markets remain the most competitive in the world.

The Coalition, and I personally, stand ready to work with the Committee and its staff as it considers these important issues.

Thank you again for the opportunity to testify at this important hearing. I would be happy to answer any questions that you may have.

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[7] The "two pot" approach has been used at the clearing level to permit hedging between positions in Government securities and repurchase agreements in Government securities and various interest rate futures or futures on Government securities, but these arrangements have been limited to proprietary positions of member firms of the clearing agencies, not customer accounts. The "two pot" approach has never been developed for customer accounts at the firm, as opposed to clearing agency, level. The primary reason for this is that significant legal and regulatory issues would need to be resolved in order to implement a "two pot" approach for customers. *See* Letter from William H. Navin, Executive Vice President and General Counsel, OCC, to Ms. Nancy M. Morris, Secretary, Securities and Exchange Commission, re: Portfolio Margin and Cross-Margin Proposals: SR–NYSE–2006–13 and SR–CBOE–2006–14, dated May 19, 2006.

[8] We note that, even though it has expressed support for a "two pot" approach to portfolio margining, the Chicago Mercantile Exchange also has acknowledged that "[t]he one pot approach generally provides the most optimal level of economic risk offsets . . . ." *See* Letter from Craig S. Donohue, President, Chicago Mercantile Exchange, to Mr. Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, re: SR–CBOE–2006–14; SR–NYSE–2006–13; Portfolio Margining and Cross Margining, dated May 9, 2006.

PROPOSED AMENDMENT TO SIPA

Under Section 78111 of SIPA

In Section (2) Customer

After safekeeping, insert the following:

"including cross-margin accounts carried as securities accounts pursuant to a portfolio margining program approved by the Commission,"

After purchasing securities, insert the following:

"and any person who has a claim for cash arising from a transaction in a cross-margin account carried as a securities account pursuant to a portfolio margining program approved by the Commission,"

In Section (4) Customer property

After customer, insert the following:

", including cross-margin accounts carried as securities accounts pursuant to a portfolio margining program approved by the Commission,"

In Section (14) Security

After the first foregoing, insert the following:

"any futures option in a cross-margin account carried as a securities account pursuant to a cross-margining program approved by the Commission"

Mr. ETHERIDGE. Thank you. And I would say to all the panelists, your full statement will be entered into the record and thank you. We have just a few minutes and I am going to try to limit my time to less than 5 minutes. If you will answer very quickly and hopefully, when we conclude here, I would say to you, at this point, that we are going to request that any other Members who want to submit questions, we will get them and ask you to respond quickly so we can use that testimony.

Mr. Zerzan, you cited FERC's action challenging the CFTC's exclusive jurisdiction as an example of why the United Kingdom is beating the U.S. in the world of over-the-counter derivatives. However, from some of the figures you cite in your written testimony, the UK's lead existed long before FERC's action arose. Given the CFMA and its legal certainty with OTC swaps and its hands-off approach for most of the OTC market, what other explanations can you give for why the U.S. is losing derivative business and why you may be ready to blame Sarbanes-Oxley. I am interested in more derivative specific regulatory problems and the Sarbanes-Oxley is a problem that has a greater impact on the securities world. You can give me a quick answer.

Mr. ZERZAN. Yes, Mr. Chairman. I apologize if it appeared that I was directly linking FERC to the UK's lead. In fact, that was meant to be an example of the uncertainty that is often cited as to why businesses will trade in the UK as opposed to the United States. They feel there is a more certain regulatory environment in which they know what their potential liabilities are.

Mr. ETHERIDGE. Okay. You don't have a specific answer other than that? Okay. Let me move to Mr. Brodsky, much of the futures industry fears losing all the benefits of a principle-based regulatory approach that the CFMA provides the industry. Should the CFTC be combined with the SEC, additionally, there are other concerns about the SEC like those illustrated in the recent GAO report that found that the SEC enforcement division is too slow to take action on enforcement cases with ⅔ of the investigations pending at the end of last year having begun 2 or 3 years earlier. Before we can talk merger, shouldn't Congress focus on improving the SEC first?

Mr. BRODSKY. You know, I think that this is a smoke screen to avoid an honest discussion about whether the agencies should be combined. If a division is inefficient, that is a micro problem. I am talking about the macro issue that we have virtually economic equivalent products being regulated by two agencies and all my colleagues on the panel complain about the concern about duplicative regulation and we suffer it right now. And whether I am before this Committee or the House Financial Services Committee or the comparable committees in the Senate, the issue is there and to pretend that it doesn't exist is not being fair to the American financial system. I think that these issues on principles-based are valid issues for discussion, but that is part of the review that I am urging that the Congress do.

Mr. ETHERIDGE. Thank you, sir. I yield to the gentleman from Kansas.

Mr. MORAN. Mr. Chairman, thank you very much. Much of our discussion with the first panel involved ECMs and I wondered if any of you would give us your synopsis of the solution to the level of regulation, if you believe additional regulation is useful, give us the key to what that regulation should be. Mr. Damgard.

Mr. DAMGARD. I think the CFTC is working pretty closely with both NYMEX and ICE right now and it sounded to me, in their testimony, that you had with Mr. Sprecher and Dr. Newsome, very close to a solution. And I think, to sum it up, if a product that incubates in an ECM becomes the equivalent of a futures contract, then to prevent any kind of disparity in the regulatory system, they should still be able to have that choice. I mean, one of our points is competition is what is lacking in many of the areas of futures with the one exception of energy and we know customers are a whole lot better off because we have two viable markets at work. One of them is a regulated market and one of them is not. But to stamp out ECMs and try to drive everything onto an existing exchange simply would serve the purposes of furthering the lack of competition.

Mr. MORAN. I have additional questions, but due to the time constraints, I will submit them to you in writing and anyone else who would like to respond, as Mr. Damgard has, I would appreciate that and yield back the balance of my time.

Mr. ETHERIDGE. The gentleman from Georgia.

Mr. MARSHALL. It looks like we are going to be able to get you all out of here and you won't have to wait for us to come back from votes. Thank you all for being here and for your testimony, most of which I missed, but I will read. Mr. Zerzan, I would simply remind you that after the last hearing that we had specifically on energy and we adjourned to the meeting room back there, you committed to me, and I hope you can live up to this commitment, that you would prepare some notes of the discussion and circulate those notes so that everybody would have an opportunity to comment on your take on what was said and argued and the positions that were taken. And it would certainly be helpful to the Committee to have that and is it possible for you to go ahead and do what we agreed you were going to do?

Mr. ZERZAN. I don't want to get your Chief of Staff in trouble, but I actually submitted those——

Mr. MARSHALL. Oh, you did. Great. I appreciate that very much. Now, have they been circulated or am I supposed to do that?

Mr. ZERZAN. I don't know.

Mr. MARSHALL. Okay, they haven't been circulated, so I will circulate to the other folks who were in that meeting. Thank you all. Thank you, Mr. Chairman.

Mr. ETHERIDGE. Thank you. Let me thank each of our panelists and I have a couple more questions I withheld and I will submit those to you and if you would respond to them. Let me thank you. Let me thank the Ranking Member. Each of you, for your testimony, for your help with the witnesses. And before we adjourn, a little bit of housekeeping business here. Under the rules of the Committee, 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 posed by a Member of the panel. This hearing of Subcommittee on General Farm Commodities and Risk Management is adjourned. Thank you very much.

[Whereupon, at 12:17 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

PREPARED STATEMENT OF DREW NIV, PRESIDENT AND CEO, FOREX CAPITAL MARKETS LLC, NEW YORK, NY

We thank the Chairman of the Subcommittee on General Farm Commodities and Risk Management, Bob Etheridge, the Ranking Member Jerry Moran, and the Members of the Subcommittee, for this opportunity to submit a statement for the record regarding the important issues facing Futures Commission Merchants and the fast growing industry of retail foreign exchange trading. My name is Drew Niv. I am the President and Chief Executive Officer of Forex Capital Markets LLC (FXCM). FXCM is regulated as a Forex Dealer Member by the National Futures Association. Forex Dealer Members are U.S. registered Futures Commission Merchants that have greater than 35% of revenue from foreign exchange.

In 2001 retail online currency trading was regulated for the first time with the passage of the Commodity Futures Modernization Act of 2000 ("CFMA"). This law required that any non-bank firm making a market in FX be registered and licensed by the Commodities Futures Trading Commission. This law was a step in the right direction and has greatly facilitated the growth of the retail forex market here in the United States. Indeed, FXCM was glad to see the CFMA become law and was the very first forex broker to be granted a license under its auspices in early 2001. Since then we have strongly supported the NFA and CFTC in their efforts to resolve many of the problems confronting the industry, including the ones that NFA President Dan Roth recently brought to the Committee's attention during his testimony on September 26, 2007.

However, there are two areas the CFMA did not address that are in need of the Congress' immediate attention. The first area is in regard to the absence of customer funds' segregation in the FX Industry. The second area relates to the continuing problem of unlicensed introducing FX brokers in the United States.

The absence of customer funds protection in the United States is currently the most pressing issue the domestic FX industry faces. This is because the CFMA did not make any adjustments to the CFTC's "segregation rule" when the law was implemented in 2001. The segregation rule stipulates that all client funds deposited for trading domestic, on exchange futures or options on futures be kept segregated from all company funds and that in the event of bankruptcy the customer's funds are legally segregated from creditors and must be returned to the clients. Because the segregation rule does not explicitly state that customer funds that are used to trade OTC derivatives, such as foreign exchange contracts, be segregated in the same manner these customers are in effect left completely unprotected. This is not the case in the other major financial centers where retail forex trading takes place, such as the United Kingdom, Canada and Hong Kong. The failure to amend the segregation rule to include CFTC registered Forex Dealer Members places customers are at a greater risk in the event of bankruptcy while simultaneously leaving the domestic FX retail industry at a severe competitive disadvantage to foreign Forex Broker Dealers.

The issue is of the utmost importance to the forex trading community and as such I have included a letter that was submitted to Chairman Peterson earlier this year that was signed by some of the largest firms in the industry in support of customer funds' segregation.

Customers can lose their funds not only when a legitimate firm goes bankrupt but when an illegitimate, unlicensed broker encourages naïve investors into trading high risk futures contracts they know nothing about. One of the problems for retail foreign exchange trading has been the prevalence of get rich quick scam artists promising riches to customers with little knowledge of the market. The CFTC has been aggressive in putting such people out of business yet there are still thousands of unlicensed firms and individuals who can legally solicit customers to trade foreign exchange. Thus this glaring potential for fraud remains a constant in the FX market and continues to leave a black mark on industry as a whole.

The best way to prevent this kind of fraud from happening is to mandate that anyone who solicits customers to trade FX be licensed with the CFTC. The CFTC already requires any non-bank firm that makes a market in foreign exchange be registered (unless they are exempt under the CFMA.) Yet the failure to hold others soliciting customers to these same standards is leading to a great deal of inefficiency in the industry. By mandating a licensing regime for anyone involved in the business of foreign exchange overnight the industry would be cleaned up as the CFTC would have a clear mandate to close down anyone not complying with the CFTC's registration requirement. As it is, the CFTC only acts after fraud has been committed and by then it is too late for customers to ever regain their funds.

We recommend that the Congress do the following in order to redress the problems described earlier.

(1) Amend the CFTC's "segregation rule" to include OTC derivatives (such as leveraged foreign exchange contracts) as part of the customer funds that cannot be legally co-mingled with company funds. Making this legal distinction will ensure that the trading public will not have to endure another RefcoFX bankruptcy debacle. Furthermore, it will inspire confidence in U.S. markets and make it easier for American firms to compete with overseas firms where these legal protections are already in place. (Please note: making such a legal distinction in no way means that we are advocating that the Federal Government should somehow insure the accounts of currency traders. The issue is merely about priority in bankruptcy. Right now currency traders have no priority in bankruptcy should their broker go bankrupt because their funds are not segregated by law. Therefore by requiring that brokers segregate customer funds we will give currency traders the same priority as do traders in Futures and Equities currently have should a futures or equity broker go bankrupt.)

(2) Mandate that introducing brokers who refer customers to registered commission merchants be licensed by the National Futures Association and regulated by the Commodities Futures Trading Commission. Right now it is illegal to solicit someone to trade stocks or exchange traded futures contracts without a license. These same standards need to be applied to anyone soliciting retail customers to trade foreign exchange. This is the next logical regulatory step as the industry works towards greater transparency and increased protection of client funds.

The domestic retail foreign exchange trading industry is one of the fastest growing industries in the nation today (five retail FX brokers made INC. Magazine's list of the fastest growing companies in America in 2006.) As such, it is important that the Congress keep pace with the growth of the industry by passing legislation that adequately protects the tens of thousands of investors who start trading in this fast growing market each year. Taking these actions lays an excellent foundation that can lead to the United States taking a position of pre-eminence in this fast growing industry. Failure to take action will lead to the United States losing the battle, not because of inadequate technology or because of a lack of effort, but because of a regulatory environment deemed backward and unresponsive to the needs of the trading public.

We look forward to working with this Subcommittee, other Congressional committees, the CFTC, the NFA, and the industry to address the important customer protection issues outlined above.

ATTACHMENT

March 2, 2007

Chairman Collin C. Peterson
Committee on Agriculture
U.S. House of Representatives
1305 Longworth Building
Washington, DC 20515

Dear Chairman Peterson:

We are writing to you to express our concern regarding the continued absence of account funds protection for foreign currency market participants who place funds on deposit with CFTC registered futures commission merchants. Since the passage of the Commodity Futures Modernization Act of 2000, retail foreign exchange has become one of the fastest growing industries in the United States. In fact, five domestic retail FX companies were named on this past year's *Inc. 500* list of fastest growing companies. These five companies comprised nearly 20% of the total number of financial services industry firms appearing on this past year's list.

Notwithstanding this extraordinary growth, current U.S. regulation in this area has failed to provide the basic customer protections necessary for this industry to continue its rapid growth. This failure jeopardizes not only a successful and growing domestic industry but needlessly exposes the participating customers to a financial risk they should not have to face. One need only look at the current fate of the 15,000 customers of RefcoFX, whose account funds were seized by creditors after Refco declared bankruptcy in 2005, as proof of the urgency of this problem.

Several other jurisdictions, including Canada, the United Kingdom, Hong Kong and Japan, have functioning regulatory regimes in place which effectively provide retail forex customers with safety of account funds protection. If Congress or the appropriate U.S. regulatory authorities do not move quickly and aggressively to address this disparity, retail forex customers both here and abroad will likely bypass the U.S. industry and choose to open accounts in jurisdictions where customer accounts have such demonstrated protection.

We respectfully request your assistance to help address this critical competitive disadvantage and its serious implications for the rapidly growing domestic FX industry.

Thank you for your time and consideration. We look forward to working with you on this critical matter. If you have any questions, please feel free to contact us.

Sincerely,

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Walter L. Lukken
Acting Chairman

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October 12, 2007

The Honorable Collin Peterson
Chairman
U.S. House of Representatives
Committee on Agriculture
1301 Longworth House Office Building
Washington, DC 20515

The Honorable Bob Goodlatte
Ranking Member
U.S. House of Representatives
Committee on Agriculture
1301 Longworth House Office Building
Washington, DC 20515

The Honorable Bob Etheridge
Chairman
U.S. House of Representatives
Committee on Agriculture,
Subcommittee on General Farm
Commodities and Risk Management
1301 Longworth House Office Building
Washington, DC 20515

The Honorable Jerry Moran
Ranking Member
U.S. House of Representatives
Committee on Agriculture,
Subcommittee on General Farm
Commodities and Risk Management
1301 Longworth House Office Building
Washington, DC 20515

Dear Chairman Peterson, Ranking Member Goodlatte, Subcommittee Chairman Etheridge, Subcommittee Ranking Member Moran:

Thank you for your recent letter regarding the Commodity Futures Trading Commission's (CFTC) exclusive jurisdiction over the trading of futures contracts on designated contract markets. This was an important topic of debate during the September 26, 2007 hearing held by the Agriculture Subcommittee on General Farm Commodities and Risk Management, and continues to be an area of great interest.

The CFTC is committed to upholding the law and our exclusive jurisdiction as defined in the Commodity Exchange Act. We take this responsibility seriously, along with our agency's mission to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets.

We continue to work diligently at the CFTC to fulfill our mission. Thank you for your support and attention to these important issues.

Sincerely,

Walt L. Lukken

Walt Lukken
Acting Chairman

WALTER LUKKEN,
Acting Chairman,
U.S. Commodity Futures Trading Commission,
Washington, D.C.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Answer.

Civil Monetary Penalties FY 2000–2008

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

[1] Includes $30,005 for civil monetary penalties imposed in prior years.
[2] Includes $617,409 for civil monetary penalties imposed in prior years.
[3] Through October 2007. Pending $125,000,000 BP Settlement Collection.

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

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

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

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

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

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

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

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

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

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

Answer. We would anticipate that the Commission would be given the authority to make determinations as to whether ECM contracts are serving a price discovery function. We also anticipate that any price-discovery determination would be based upon a contract's behavior over some reasonable length of time, as the Commission would want to avoid a situation where contracts are moving in and out of price-discovery status.

Question 4. Last year the Commission testified that the changes proposed in Title 2 of HR 4473 (the CFTC reauthorization bill in the 109th) specific to natural gas price transparency were not necessary. Has the Commission changed its position?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Attachment

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

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

Attachment—Continued

Senator Levin's "Close the Enron Loophole Act" S. 2058	CFTC Proposal significant price discovery contracts on ECMs
14. New Section 2(j)(4)(N) requires a trading facility to establish fitness standards for directors and members of disciplinary committees	Not applicable to CFTC proposal.
15. New Section 2(j)(4)(O) requires a trading facility to establish rules governing conflicts of interest in the decision making process	Not applicable to CFTC proposal.
16. New Section 2(j)(4)(P) requires a trading facility to maintain all business records for 5 years	Not applicable to CFTC proposal.
17. New Section 2(j)(4)(Q) requires a trading facility to avoid adopting rules that create an unreasonable restraint of trade or impose anti-competitive burdens on trading on the facility	Not applicable to CFTC proposal.
B. Criteria for Energy Trading Facilities—new section 2(j)(5) provides that an energy trading facility must continue to comply with all of the criteria in section 2(j)(4) to continue operation, and that violation of any criteria shall constitute a violation of the CEA.	Core Principles apply to ECMs trading significant price discovery contracts on an ongoing basis. Violations of the provisions of proposed CEA Section 2(h)(7) constitute violations of the CEA.
C. Position Limits and Accountability—new section 2(j)(6) directs the Commission 1. to ensure that the position limits and accountability levels that are established for energy trading facilities are on a parity with the position limits and accountability levels established for similar contracts traded on a DCM and applied in a functionally equivalent manner, 2. to take action as necessary to reduce potential threat of price manipulation, excessive speculation, price distortion or disruption of delivery or cash-settlement process, and 3. to obtain information from a trader regarding the trader's exchange and off-exchange positions.	Adds proposed CEA Section 2(h)(7)(C)(iv) Core Principle—position limitations or accountability. Also, amends CEA Sections 4g and 4i regarding recordkeeping and large trader reporting, and Section 8a regarding emergency authority, for significant price discovery contracts.
D. Criteria for Commission Determination—new section 2(j)(6)(D) specifies criteria the Commission or exchange may consider when determining whether to require a trader to limit, reduce, or liquidate a position including:	Not applicable to CFTC proposal.

1. person's open interest relative to the total open interest 2. daily volume of contract 3. person's overall position in related contracts, including options, and the overall open interest or liquidity in the related contracts and options 4. potential for positions to cause or allow price manipulation, excessive speculation, price distortion, or disruption of delivery or cash-settlement process 5. person's compliance record 6. any justification provided by person for such position, and 7. other factors as deemed appropriate by Commission	
E. Information for Price Discovery Determination—Section 2(d) amends other provisions of the CEA to enable the Commission to obtain information from an electronic trading facility or a derivatives transaction execution facility to evaluate whether the energy trading facility performs a price discovery function	Conforming amendment (d) amends Section 2(h)(5) to extend CFTC's special call authority for ECMs to obtaining information to make a significant price discovery determination. Also, significant price discovery determination process subject to CFTC rulemaking authority under proposed CEA Section 2(h)(7)(A).
IV. Section 3. Reporting of Energy Trades A. Section 3 of S. 2058 adds a new CEA section 2(K) which requires U.S. persons who trade certain energy contracts on a foreign board of trade ("FBOT") to keep records and to report large trades.	*Analogous Provisions in CFTC Proposal.* Not applicable CFTC proposal.
V. Antifraud Authority A. Section 4 of S. 2058 amends Section 4b of the CEA to clarify the CFTC's authority to bring fraud actions in off-exchange principal-to-principal futures transactions.	Analogous Provisions in CFTC Proposal. Outside scope of proposal regarding significant price discovery contracts trading on ECMs; CFTC supports including this provision as part of CFTC reauthorization.
VI. Commission Rulemaking A. Section 5 of S. 2058 requires the CFTC to issue proposed rules within 180 days regarding requirements for an application for registration for an energy trading facility. CFTC must finalize rule within 270 days.	*Analogous Provisions in CFTC Proposal.* Adds proposed CEA Section 2(h)(7)(A) requiring CFTC rulemaking to implement the provisions of this legislation.
VII. Conforming Amendments	*Analogous Provisions in CFTC Proposal.*

Attachment—Continued

Senator Levin's "Close the Enron Loophole Act" S. 2058	CFTC Proposal significant price discovery contracts on ECMs
A. Section 2 of S. 2058 includes various CEA conforming amendments to provide a comparable degree of CFTC authority over operations of registered energy trading facilities as exists with respect to DCMs.	Adds conforming amendments to : CEA Sections (2)(a)(1)(A)—exclusive jurisdiction over significant price discovery contracts on ECMs; CEA Section 2(h)(4)(D)—remove existing significant price discovery function provision applicable to ECMs in light of new Core Principle in CEA Section 2(h)(7)(C)(vi) requiring daily publication of certain trading information; CEA Section 5c—issuance of CFTC interpretations regarding compliance with Core Principles, delegation of functions under Core Principles, violations of Core Principles; CEA Section 8a—authority to alter or supplement rules of the trading facility and to share information with the trading facility.

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The Honorable Bob Etheridge
Chairman
House Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
United States House of Representatives
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for the opportunity to testify before your Subcommittee on September 26, 2007 on the reauthorization of the Commodity Futures Trading Commission (CFTC). You have asked me to respond to several follow-up questions for inclusion in the record of that hearing. Questions and responses are below.

Question: Senator Levin recently introduced S. 2058, the Close Enron Loophole Act. It would create a new category of "energy trading facility" upon which greater regulatory oversight would apply should the facility trade energy-related contracts that are either cleared by the facility or perform a price discovery function in the futures or cash market for that energy commodity. Please comment on this legislation introduced by Senator Levin.

Response: The Senate Permanent Subcommittee on Investigations (PSI), under Chairman Levin, conducted a well-documented and thorough analysis in its investigation of speculation in the natural gas market. The PSI's analysis confirmed with unequivocal evidence New York Mercantile Exchange's (NYMEX) repeated assertions that the natural gas markets on the NYMEX and on the Intercontinental Exchange (ICE) are tightly linked. The natural gas market has evolved in a manner that could not have been anticipated when the CFMA was adopted. The CFMA exempted from regulation bilateral trading between eligible participants in energy commodities on electronic trading platforms. We believe that a legislative solution is necessary to ensure effective regulatory oversight of exempt commodities that are tied to the regulated exchanges. NYMEX has reviewed and provided comment on several legislative proposals to address regulation of energy commodities traded on exempt commercial markets (ECMs). At this point, NYMEX has not endorsed any of those proposals.

Senator Levin's bill is a well-thought out and expertly drafted piece of legislation that undoubtedly will solve the problems identified in the Amaranth Investigation. It establishes a new category of registered facility, Energy Trading Facility, for certain cleared contracts in energy commodities or contracts in energy commodities determined by the CFTC to perform a significant price discovery function. It is carefully crafted to ensure that the CFTC has the proper authority to enforce the new requirements placed on the trading facility.

The bill would require large trader reporting, position limits or accountability levels, and it would impose a self-regulatory function on the energy trading facility to ensure that the market enforces its rules. Although we have not endorsed Senator Levin's bill in its entirety, these are very important provisions which we support.

While Senator Levin's approach, indeed, will achieve the desired regulatory and public policy goals, we believe that there are other ways to address the concerns as well. Accordingly, NYMEX is open to exploring other legislative solutions. NYMEX prefers a narrow and targeted approach that would focus only on the specific problem identified in the Amaranth Investigation and similar linked market situations that develop involving exempt commodities. It would encompass "linked" commodities traded on an ECM and block trades in those "linked" commodities, regardless of whether the trades are cleared, so long as they are "linked" to transactions on the regulated exchange. Position limits for physically settled contracts and position accountability levels for financially settled contracts would be imposed on linked contracts, as well as large trader reporting to avoid the Amaranth situation of carrying very large positions off of the regulator's radar screen. It may be difficult to predict or anticipate the appropriate breadth and depth of the coverage of the legislative language given how quickly the markets evolve. Therefore, NYMEX, may in time support a broader fix than I have outlined here as the market conditions may dictate. Finally, as we have noted previously, we do not believe that the case has been made for regulating products traded in the traditional OTC bilateral market.

Questions: It has been suggested that exempt commercial markets (ECMs) are the source for innovation in the derivatives markets. Does innovation also occur on the regulated designated contract markets? Also, does some of the innovation claimed by ECMs borrow from pioneering products and services introduced elsewhere, such as on designated contract markets?

Responses: DCMs provide a substantial degree of innovation to derivatives markets. These innovations include a broad variety of new products and services. In addition, DCMs continually refine the efficiencies of their operations and procedures and also seek to facilitate internal efficiencies, including risk management procedures, for their market users and clearing member firms.

At NYMEX, for example, we lead the derivatives industry in the listing of innovative new products. Since the passage of the CFMA, we have listed more than 350 new contracts for trading and clearing. One or more ECMs subsequently listed "look-alike" contracts that not only duplicated our exact product specifications but also used our daily and final settlement prices. Thus, much of what is currently being claimed as innovation by ECMs instead involves merely copying innovative products that were first championed by a DCM.

Please let me know if I can be of further assistance.

Sincerely,

Jim Newsome

Dr. James E. Newsome
President and CEO

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