

TESTIMONY OF
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HEARING TO REVIEW PROPOSALS
TO ESTABLISH EXCHANGES TRADING “MOVIE FUTURES”

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES AND RISK MANAGEMENT
HOUSE COMMITTEE ON AGRICULTURE

Chairman Boswell, Ranking Member Moran, and members of the Subcommittee, thank you for inviting the Commodity Futures Trading Commission (“CFTC” or “Commission”) to testify at this hearing to review proposals to establish exchanges trading “movie futures.” The Commission appreciates this opportunity to present to the Subcommittee information about the standards and procedures used by the Commission, pursuant to the Commodity Exchange Act (“CEA”), to review applications for new exchanges seeking to trade futures contracts.

This testimony will address the standards and procedures that approved exchanges—called “designated contract markets” (“DCMs”)—must follow in order to trade new futures contracts. In addition, this testimony will describe the Commission’s activities with respect to the two applications recently approved for DCMs that intend to trade futures contracts whose

settlement prices are based on the level of box office receipts from movie theaters (“movie futures” or “box office receipt futures”), as well as the status of the Commission’s reviews of those proposed contracts.

The CFTC and its Mission

First, I would like to provide some background on the CFTC and its mission. The CFTC was established in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The CFTC assures the economic utility of the futures markets by encouraging their competitiveness and efficiency, protecting market participants against fraud, manipulation, and abusive trading practices, and ensuring the financial integrity of the clearing process. Through effective oversight, the CFTC enables the futures markets to serve the important economic function of providing a means for price discovery and offsetting price risk.

The CFTC currently oversees 16 DCMs and one exempt commercial market that lists a significant price discovery contract. The CFTC also oversees 14 clearinghouses, which reduce systemic risks by providing a guarantee of performance for all cleared trades. The CFTC oversees 66,187 registrants, which includes 51,921 salespersons, 1,277 commodity pool operators, 2,568 commodity trading advisors, 7,114 floor brokers, 1,447 floor traders, 166 futures commission merchants, and 1,694 introducing brokers. In 2009, 2,051 contracts were listed for trading on CFTC-regulated facilities, with a total trading volume of nearly 3 billion contracts.

There are several critical elements of the CFTC's oversight of futures and option trading. These include, among other things, regular surveillance of traders' positions and trading activity to detect and deter manipulation, market congestion, and abusive and unfair trading practices. Another fundamental component of market oversight involves the evaluation of the futures exchanges' capabilities and operations to ensure that they can fulfill the statutory requirements and their self-regulatory obligations. Such reviews are conducted initially for prospective DCM applicants and regularly thereafter through comprehensive staff evaluations of the exchanges' operations (called rule enforcement reviews).

Application Process for Contract Market Designation

An entity that seeks to establish an exchange for the trading of commodity futures, options and futures options must apply to the Commission to be designated as a contract market. In order to obtain Commission designation, an exchange must demonstrate to the Commission that it complies with the requirements of the CEA. Specifically, the applicant must make a showing that it meets 8 designation criteria and complies with 18 core principles as specified in the CEA.

In general, to meet the requirements of the designation criteria and the core principles, the exchange applicant must demonstrate, among other things, that it has rules defining the manner in which it intends to operate and that it has rules, systems and structures to ensure the market and financial integrity of contracts to be traded on the exchange. For example, the designation criteria require an exchange to have systems in place to prevent market manipulation, to ensure fair and equitable trading, and to arrange for the clearing of transactions through a registered clearing organization. The core principles require an exchange to provide a competitive, open,

and efficient market, only list for trading on the exchange contracts that are not readily susceptible to manipulation, establish and enforce position limits or accountability levels, and monitor trades for price distortion and disruptions of delivery or cash settled process. The core principles also address such issues as composition of boards, fitness standards for directors and members of the disciplinary committee, conflicts of interest in the decision-making process, and the emergency authority of the exchange and its management.

The CEA requires that the Commission approve or deny a designation application within 180 days of the filing of the application (Section 6(a) of the CEA, 7 U.S.C. §8(a)). If the Commission denies the application, it must specify the grounds for the denial. Following a refusal to designate an applicant as a contract market, the Commission must provide the applicant with an opportunity for a hearing on the record before the Commission (Section 6(a), 7 U.S.C. §8(a)). The applicant thereafter has a right to appeal an adverse decision directly to a federal appeals court (5 U.S.C. § 706(2)).

The statute also contains a provision for staying the running of the 180-day time limit when an exchange is notified that the application for contract market designation is materially incomplete, and provides the Commission with at least sixty days for review once the application has been resubmitted in completed form.

CFTC Review of DCM Applications

The review of new exchange applications is a key element of the CFTC's oversight program. Such reviews are designed to ensure that the applicant has the ability to comply with all statutory and regulatory requirements. The review encompasses all aspects of the applicant's

proposed operations, and it is comprehensive in its scope. Additionally, although not required by law, the CFTC's policy is to post all pending applications on its website, so that interested parties can comment on the merits of the filing.

The CFTC staff evaluates an applicant's ability to comply with the designation criteria and the core principles by conducting a thorough examination of the following elements of the proposed exchange:

- the rulebook to ensure that the exchange has rules that promote transparent, fair and competitive markets, such as rules describing operation of the market, providing trading parameters and detailing the rights and obligations of participants in the market;
- clearing arrangements and settlement procedures;
- surveillance systems, staffing and capabilities, including the exchange's ability to obtain large trader and transaction data to identify unusual price changes and concentrated positions and to monitor position limit violations;
- the adoption of trade execution systems and procedures to ensure the integrity of trades, business continuity and data retention and to allow the exchange to carry out trade practice surveillance;
- disciplinary procedures that address rule violations and dispute resolution programs;
- procedures for having an open, competitive and transparent trading system to provide for the price discovery function of the centralized marketplace and to make available information to all traders on prices, volume and terms, through

public dissemination of price and trade activity information as well contract terms;

- procedures and rules to minimize conflicts of interest, including composition requirements for the Board of Directors and the establishment of a regulatory oversight committee;
- procedures to take appropriate emergency action to protect traders and the market in cases where intervention is required; and
- the exchange's rules, trading protocols or policies to ensure that they do not result in any unreasonable restraints of trade or any anticompetitive burden on trading in the market.

Upon the conclusion of its review, the CFTC staff evaluates whether the applicant meets the requirements of the CEA, and recommends to the Commission whether to issue an order designating the exchange as a contract market. If the Commission finds that the applicant meets the requirements of the CEA and votes to designate, it issues an Order of Designation which may impose certain conditions involving financial, jurisdictional and regulatory compliance issues.

In conjunction with the review of a new DCM application, the CFTC staff typically inquires about the types of contracts to be traded on the exchange. Information about potential products to be traded helps inform the staff about the nature of the surveillance and oversight measures the exchange should have in place. The purpose of such information is to address, in a generic way, the exchange's ability to comply with designation criteria and core principles that address such issues as contract manipulation, general availability of information involving contract terms, mechanisms for executing trades, and recording and storage of trade information.

Notwithstanding the fact that the Commission may generally be cognizant during the course of the application review process of the possible contracts that an applicant plans to offer, under the CEA and the Commission's regulations, the contract market designation process and the contract approval process are separate and distinct processes subject to different review procedures, timeframes, and approval standards.¹ In contrast to the contract market approval process under the CEA prior to the passage of the Commodity Futures Modernization Act ("CFMA"), in which a prospective exchange had to include a contract as part of its application package, since the passage of the CFMA contract market applicants have the option to submit an application that does not include any proposed product.²

Contract certification and approval

The CEA provides that a DCM may either self-certify new futures and option contracts or voluntarily request approval of new products. To self-certify a new contract, the exchange must provide to the Commission, at a minimum, the rules that establish or relate to the contract's terms and conditions, along with a statement certifying that the contract complies with the Act and the Commission's regulations thereunder. A self-certification filing must be received by the Commission prior to the open of business on the business day prior to the intended initial listing day. Commission staff conducts a due-diligence review of the contract to verify the validity of

¹ See section 5c of the Act, 7 U.S.C. §7a-2(c), section 6(a) of the Act, 7 U.S.C. §8(a), regulation 38.3, 17 C.F.R. §38.3, regulation 38.4, 17 C.F.R. §38.4, and regulation 40.3, 17 C.F.R. §40.3.

² Because the CEA, as amended by the CFMA, no longer requires that applicants include a proposed contract in their application to be designated as a DCM, staff's review of the application is limited regarding compliance with two contract-specific core principles; specifically, Core Principles 3 (Contracts Not Readily Subject to Manipulation) and 5 (Position Limits or Accountability). While the other core principles require DCMs to have structures, rules and procedures to address generic concerns, Core Principles 3 and 5 are contract-specific. Staff is, therefore, limited in its ability to assess compliance with those two core principles when a DCM application does not include a contract. Instead, the analysis of a DCM's compliance with Core Principles 3 and 5 is primarily carried out in the context of the contract review process.

the exchange's self-certification and, when necessary, may request amendments to the contract or additional information related to the contract or the underlying cash market.

With respect to products submitted for approval, the CEA specifies that the Commission must act to approve or disapprove within 90 days of the request for approval (Section 5c(c)(2)(C) of the CEA, 7 U.S.C. §7a-2(c)(2)(C)). The Commission's regulations state that products submitted for approval may be deemed approved 45 days after the filing if the filing is complete and is not amended by the exchange, except for amendments made at the request of the Commission (17 C.F.R. §40.3(b)). The review period may be extended to 90 days if the product raises novel or complex issues that require additional time for review or is of major economic significance (17 C.F.R. §40.3(c)). All new contract filings are posted on the Commission's website, and the public is welcome to comment on those filings. The CEA provides, "The Commission shall approve any such new contract or instrument . . . unless the Commission finds that the new contract or instrument . . . would violate the Act." (Section 5c(c)(3) of the CEA, 7 U.S.C. §7a-2(c)(3)).

The primary focus of the Commission staff's review of a contract approval request is to ensure that the contract is not readily susceptible to manipulation (Core Principle 3) and that the contract has speculative position limits or position accountability, as appropriate (Core Principle 5). If an exchange seeks approval of a contract, it must demonstrate that the terms and conditions as a whole will result in a deliverable supply such that the contract will not be conducive to price manipulation or distortion, in accordance with the Commission's Guideline No. 1 (17 C.F.R. Part 40, Appendix A (2009)). For cash-settled contracts, such as the box office receipts contracts filed for approval by MDEX and Cantor, Guideline No. 1 specifies that the

final cash settlement price must be not readily susceptible to manipulation, must be reflective of the underlying market, and must be reliable, acceptable for hedging, publicly available and timely.

MDEX and Cantor Applications for DCMs

The Commission has recently approved contract market designation for two applicants that contemplate listing box office receipt contracts. These exchanges are Media Derivatives Inc. and the Cantor Futures Exchange.

Media Derivatives Inc. (“MDEX”) was formed in April 2007 to operate as an electronic futures exchange to trade contracts based on movie box office revenues and other unspecified entertainment industry contracts. It is a Delaware corporation and wholly-owned subsidiary of Veriana Networks, Inc., a privately-held media and technology company. MDEX submitted its application for contract market designation on September 25, 2009; the voluntary public comment period was open until November 5, 2009. That application was preceded by numerous draft materials submitted by MDEX to the Commission, as well as numerous supplemental materials submitted after the formal filing date.

Some notable features of the MDEX application: MDEX has contracted with the National Futures Association (“NFA”) to provide it with regulatory services and has an agreement with the Minneapolis Grain Exchange to provide clearing services. In addition to its reliance on NFA, MDEX will conduct its own real-time surveillance and some general market compliance. MDEX will be an intermediated market and will utilize an electronic trading system with web-based access or direct connections. MDEX initially intends to trade Opening Weekend Motion

Picture Revenue contracts in the form of binary options and collared futures. That contract review process is separate from its DCM application approval.

The Cantor Futures Exchange (“Cantor”) was created to operate a non-intermediated electronic trading system to likewise trade, among other things, futures contracts on movie box office receipts. Cantor operates as a Delaware Limited Partnership and is a wholly-owned subsidiary of Cantor Fitzgerald, L.P., a global financial service firm. Cantor submitted its application to become a DCM on November 28, 2008; the voluntary public comment period was open until January 28, 2009.

The NFA will provide regulatory services to Cantor, including general market compliance and surveillance responsibilities. Like MDEX, Cantor will be responsible for certain aspects of its market surveillance and its market compliance. As proposed, clearing services will be provided by the Cantor Clearinghouse, which is also a wholly-owned subsidiary of Cantor Fitzgerald, L.P., and which submitted an application to become registered as a derivatives clearing organization contemporaneously with the Cantor DCM application. As a non-intermediated exchange, Cantor has undertaken certain functions that normally fall to intermediaries, such as filing certain reports with the Commission and providing trade confirmations and account statements to market participants.

As with the MDEX application, Commission staff was aware of Cantor’s intention to initially list box office receipt contracts. Again, that contract review process is separate from its exchange application approval.

Staff's review of both the MDEX and Cantor applications addressed each of the regulatory requirements mentioned above.³ The CFTC staff carefully considered the applicants' submitted materials, representations made, and demonstrations related to the 8 designation criteria and 18 core principles, and in light of the expected novel products that they intend to list, put special emphasis on those designation criteria and core principles relating to the prevention of market manipulation and fair and equitable trading.

More specifically, staff considered whether MDEX and Cantor had the ability generally to detect and prevent market manipulation and trade practice violations, and also considered the extra steps MDEX and Cantor would need to take if they offered futures contracts based on box office revenue, such as the implementation of firewalls within a movie studio. In this regard, staff considered the sources of data for box office revenue figures, whether the information provided by these sources is reliable and verifiable, what extra tools MDEX and Cantor possess to track this information and analyze its reliability, and what extra market surveillance resources each exchange would be able to use to detect attempted manipulation or abusive trading practices.

Staff also considered the fact that NFA will be providing regulatory services for both applicants. NFA currently provides regulatory services to four other DCMs, and the Commission has previously found that NFA maintains acceptable surveillance and compliance practices in the context of other designated contract markets to which it provides regulatory services.

³ Except, as noted in note 2, *supra*, if the application does not include a contract, the Commission is limited in its review of the applicant's ability to comply with Core Principles 3 and 5 in the absence of a contract.

Staff concluded that the MDEX application satisfied the requirements of the designation criteria and core principles, and recommended Commission approval of the exchange. The Commission approved the designation of MDEX as a contract market on April 16, 2010.

Staff concluded that the Cantor application satisfied the requirements of the designation criteria and core principles, and recommended Commission approval of the exchange. Cantor was designated as a contract market on April 20, 2010.

The Orders of designation for both MDEX and Cantor require them to submit to the Commission for review and approval any new class or category of media-related products prior to listing them for trading.

MDEX and Cantor Requests for Contract Approval

MDEX's and Cantor's proposed contracts are under active consideration for Commission approval as they were not part of the Commission's designation of MDEX and Cantor as DCMs. In conditioning these designations on the submission of the exchanges' initial contracts and all other new classes of media-related contracts for prior Commission approval, the Commission recognized that media contracts may require special review of other issues to ensure, among other things, that the contracts are consistent with the Act and the Commission's regulations and that the exchanges have appropriate surveillance and compliance measures in keeping with the unique nature of these contracts.

On March 9, MDEX requested approval of its collared futures and binary option contracts based on the Opening Weekend Motion Picture Revenues for the film *Takers*. The 45-day fast track review period would have ended on April 23, but the staff extended that review

period by an additional 45 days so that it now expires at the end of the statutory review period (90 days after Commission receipt). That statutory review period ends June 7, 2010. MDEX has indicated that it also intends to list other media-related futures contracts.

On March 30, Cantor Exchange requested approval of its Domestic Box Office Receipts futures contract based on the film *The Expendables*. The Commission's 45-day review period for that contract ends May 14, but the Commission may extend that review period to June 28, 2010. Cantor has stated that it also intends to list other, non-media-related, more traditional futures contracts.

The Commission will specifically evaluate whether the MDEX and Cantor contracts are not readily susceptible to manipulation and whether the cash settlement provisions of each contract meet the Commission's Guideline No. 1 requirements, among other criteria. In addition, the Commission will consider other issues that have been raised as well as comments filed by interested parties related to those contracts.

Conclusion

In summary, the Commission is committed to fulfilling its statutory responsibilities to oversee the futures markets in a timely, efficient, and thorough manner. The Commission has carefully reviewed the two recent DCM applications and determined that they met the statutory standards. With respect to the contracts submitted for approval, the Commission similarly will conduct a thorough and careful review, seek and consider public comments, and make a decision based on whether the contracts under review meet the statutory criteria.

Thank you, and I look forward to answering any questions.