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Testimony

Written Testimony of Acting Chairman Walter Lukken Before the Subcommittee on Oversight and Investigations Committee on Energy and Commerce United States House of Representatives December 12, 2007

Thank you, Mr. Chairman and members of the Subcommittee. On behalf of the Commodity Futures Trading Commission (CFTC or Commission), I appreciate the opportunity to discuss the CFTC, our role with respect to the futures markets, and our view of the markets as the government regulator charged with overseeing them.

CFTC Mission

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The CFTC's mission is broadly two-fold: to protect the public and market users from manipulation, fraud, and abusive practices; and to promote open, competitive and financially sound markets for commodity futures and options. To do this, the Commission employs a highly-skilled and dedicated staff who work to oversee the markets and address any suspicious or illegal market activity.

The Commodity Exchange Act (CEA or Act) grants the Commission exclusive jurisdiction with respect to accounts, agreements, and transactions involving commodity futures and options contracts that are required to be traded or executed on an exchange or a designated contract market, also known as a "DCM." One of the purposes of the CEA is "to serve the public interests . . . through a system of effective self-regulation of trading facilities . . . under the oversight of the Commission." DCMs are regulated entities that are self-regulatory organizations (SROs) subject to comprehensive oversight by the CFTC. DCMs can list for trading any type of contract, they can permit intermediation, and all types of traders (including retail traders) are permitted to participate in their markets. The CFTC's Division of Market Oversight (DMO) is responsible for monitoring and evaluating a DCM's operations and it conducts market surveillance of all activity on DCMs, as described below.

DCMs must comply with a number of designation criteria and core principles as a condition for initial CFTC approval and continuing operation. Once operational, DCMs, as self regulatory organizations (SROs), must establish and devote resources toward an effective oversight program, which includes surveillance of all activity on their markets to detect and deter manipulation and trading abuses. The CFTC regularly assesses the regulatory and oversight activities of DCMs through periodic examinations of DCMs' self-regulatory programs to evaluate their compliance with applicable core principles under the Act and the Commission's regulations.

The CFTC's market surveillance mission regarding DCM activity is to ensure market integrity and customer protection in the futures markets. Traders establishing positions on DCMs are subject to reporting requirements so that CFTC staff and the DCM can evaluate position sizes to detect and deter manipulation. In addition, trade practice surveillance involves compilation and monitoring of transactional-level data by the Commission and the DCM to detect and deter abusive trading such as wash sales, money laundering and trading ahead of customers (trade practice surveillance).

Another mission of market surveillance is to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for the estimated 1,400 active futures and option contracts in the U.S., CFTC market surveillance staff monitors the activities of large traders, key price relationships, and relevant supply and demand factors to ensure market integrity.

Surveillance economists prepare weekly summary reports for futures and option contracts that are approaching their expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advises the Commissioners and senior staff of significant market developments at weekly surveillance meetings (non-public, closed meetings) so they will be prepared to take action if necessary.

It should be noted that surveillance of DCM trading is not conducted exclusively by the Commission. As SROs, DCMs have significant statutory surveillance responsibilities. Typically, however, surveillance issues are handled jointly by Commission staff and the relevant DCM. Typically, the Commission gives the DCM, as the front-line regulator, the first opportunity to resolve any issue arising in its markets. If a DCM fails to take actions that the Commission deems appropriate, the Commission has broad emergency powers under the CEA to order the DCM to take specific actions. The Commission has had to take emergency action four times in its history.

The Commission's Division of Enforcement (Enforcement) also plays a large role in maintaining the fairness and integrity of our markets. At any one time, Enforcement is investigating and litigating with approximately 700 to 1000 individuals and corporations for alleged fraud, manipulation, and other illegal conduct. Working closely with the President's Corporate Fraud Task Force, Enforcement is staffed with skilled professionals who prosecute cases involving complex over-the-counter (OTC) and on-exchange transactions. Enforcement also routinely assists in related criminal prosecutions by domestic and international law enforcement bodies.

During the last five years, Enforcement maintained a record level of investigations and prosecutions in nearly all market areas, including attempted manipulation, manipulation, squeezes and corners, false reporting, hedge fund fraud, off-exchange foreign currency fraud, brokerage compliance and supervisory violations, wash trading, trade practice misconduct, and registration issues.

In the energy sector, Enforcement investigated and prosecuted Enron and BP, dozens of other energy companies, and hundreds of energy traders and hedge funds. At the same time, in other market sectors, Enforcement prosecuted more than 50 hedge funds and commodity pool operators for various violations, and filed actions against more than 360 individuals and companies for off-exchange foreign currency fraud and misconduct.

In CFTC Enforcement actions in federal court, the CFTC may obtain temporary statutory restraining orders and preliminary and permanent injunctions, restitution to victims, disgorgement of ill gotten gains, civil monetary penalties, appointment of a receiver, and the freezing of assets.

The CFTC also refers enforcement matters to the Department of Justice. Criminal activity involving commodity-related instruments can result in prosecution for criminal violations of the CEA and for violations of federal criminal statutes, such as mail fraud or wire fraud.

Exempt Commercial Markets

The Commodity Futures Modernization Act of 2000 (CFMA) included a provision to create a new trading facility known as an Exempt Commercial Market (ECM). ECMs are not "registered with, or designated, recognized, licensed or approved by the Commission." ECMs, as well as transactions executed on ECMs, are statutorily exempt from most provisions of the CEA. Trading on an ECM is not subject to regular, ongoing market surveillance oversight by the Commission. The Commission does retain fraud and manipulation authority over ECMs.

To assist the Commission in carrying out its fraud and manipulation authority, ECMs are required to maintain a record of allegations or complaints received by the trading facility concerning instances of suspected fraud or manipulation and to forward them to the Commission.

ECMs are also subject to certain limited reporting requirements that require an ECM to identify those transactions conducted on the facility with respect to which the ECM intends to rely on the statutory Section 2(h)(3) exemption, and which averaged five or more trades per day over the most recent calendar quarter. With respect to such transactions, the ECM is required to transmit weekly to the Commission certain basic trade information. Information provided by ECMs can provide Commission surveillance staff with information regarding price spikes or unusual divergence between the price of a commodity traded on an ECM and the price of a related commodity traded on a DCM but do not identify individual traders.

In addition, an ECM must maintain for five years, and make available for inspection upon request by the Commission, records of its activities related to its business as an electronic trading facility, including audit trail information sufficient to enable the Commission to reconstruct trading activity, and the name and address of each participant authorized to enter into transactions on the facility. Should the Commission need further information from an ECM, the Commission has the authority to issue a "special call." A special call to an ECM is simply an indication that the Commission's staff is seeking additional information. A special call, in and of itself, is not evidence of improper or illegal market behavior.

Energy products are eligible to be traded on ECMs by institutional participants. Due primarily to the non-retail nature of these markets and the types of transactions executed, policymakers believed the risks associated with these institutional exchanges were low, thus the lower regulatory requirements for these markets.

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

With this as a backdrop, in September 2007, the Commission convened a hearing to examine the oversight of trading on DCMs and ECMs. Commission staff, exchanges, ECMs, and industry and consumer groups testified before the Commission in a productive debate of the relevant issues. Based on this hearing, in October, the Commission presented a report to Congress detailing the Commission's findings and recommendations regarding these energy markets.

Price discovery is a key determinant to Commission regulation and oversight, as others outside the marketplace begin to use prices to conduct business, such as farmers, utilities and others. As such, price discovery was the primary focus when the CFTC began its review of the regulation of ECMs.

Although ECMs have been evolving over time, the relatively recent linkage of ECM contract settlement prices to DCM futures contract settlement prices raised the question of whether the CFTC has the necessary authority to police these markets for manipulation and abuse. Linkage of contract settlement prices was not contemplated at the time of the CFMA nor at the time of the Commission's 2004 rulemaking regarding ECMs that perform a significant price discovery function. Nevertheless, the Commission is now concerned that ECM cash-settled "look-alike" contracts may provide an incentive to manipulate the settlement price of the underlying DCM futures contract to benefit positions in the "look-alike" ECM contract.

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

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

However, the reality that some ECM contracts are serving a significant price discovery function leads the Commission to conclude that changes to the CEA are necessary in order for the

Commission to detect and prevent manipulation in these markets. To that end, the Commission issued a report in October recommending changes to the CEA that would require large trader position reporting; position limits or accountability levels; self-regulatory responsibility; and emergency authority over ECM contracts determined to serve a significant price discovery function. These recommendations, crafted in consultation with the other members of the President's Working Group on Financial Markets, have the support of the entire Commission. I am pleased to report that the House Agriculture Committee, which is the CFTC's authorizing committee, has circulated a discussion draft bill for possible markup that includes, among other things, language to implement the Commission's recommendations.

As another outgrowth of the Commission hearing, the Commission is in the process of establishing an Energy Markets Advisory Committee to conduct periodic public meetings on issues affecting energy producers, distributors, market users and consumers in an attempt to facilitate discussion and policy decisions as these markets evolve. Moreover, the CFTC intends to work with FERC in an effort to jointly develop best practices for utilities and others who use the prices of regulated futures markets as benchmarks in pricing their energy products.

I am confident that the Commission's actions strike the right balance between ensuring that these markets remain free of manipulative conduct and still allowing the markets to grow and innovate on U.S. soil.

<u>CFTC Coordination with FERC</u>

The Energy Policy Act of 2005 (EPAct) marked an important milestone in the on-going debate over the appropriate policy for regulating trading activities in our nation's energy markets. As called for by the EPAct, the CFTC and FERC, in October 2005, entered into a Memorandum of Understanding (MOU) to coordinate information sharing. Accordingly, the respective staffs of the Commission and FERC are authorized to share information concerning various issues in the energy markets without the need for cumbersome access requests for each particular matter. To that end, Commission staff remain in regular contact with counterparts at FERC, and FERC staff is routinely invited to attend Commission enforcement briefings and surveillance meetings. The Commission's Enforcement staff also meets quarterly with FERC counterparts to share information on issues and matters of mutual interest.

The CFTC and FERC share the common goal of ensuring that the energy markets remain free from manipulation. I strongly support the broad grant of enforcement authority provided to FERC in the EPAct of 2005 to prevent manipulation of the physical energy markets as well as the goal of avoiding regulatory gaps in the oversight of these markets.

Since the CFTC and FERC entered into the MOU, our agencies have had a largely positive, collaborative relationship. I am committed to continually developing this cooperation given the inter-relationship between the futures and physical energy markets. As the MOU recognizes, Congress granted the CFTC exclusive jurisdiction over the futures markets in connection with FERC's new anti-manipulation powers. These mandates need not be inconsistent, as evidenced by the working relationship we share with other federal and state enforcement authorities. I am committed to finding a similar balance with FERC. Already, our staffs have met to discuss the current MOU and any possible changes to it that would further coordinate our efforts. We are also discussing ways to improve communication between Commissions to enhance collaboration and ideas to educate users of the markets on best practices for benchmarking against these exchange products. I am hopeful that these efforts will help to align our mandates going forward.

<u>Speculation in the Commodities Markets</u>

The current market environment has brought concern about the role that speculators play in affecting prices in our markets. The proper and efficient functioning of the futures markets requires both speculators and hedgers. While certain targeted controls on speculation are appropriate, speculators, as a class, provide the market liquidity to allow hedgers to manage various commercial risks. Unnecessary limitations on the amount of speculation that an individual or entity may engage in could limit the amount of liquidity in the marketplace, the ability of hedgers to manage risks, and the information flow into the marketplace, which could in turn negatively affect the price discovery process and the hedging function of the marketplace.

Recently, the CFTC's Office of Chief Economist examined the markets and the role that speculators play in them. The staff studied the relationship between futures prices and the positions of managed money traders (MMTs), commonly known as hedge funds, for the natural gas and crude oil futures markets. The staff also examined the relationship between the positions of large speculators such as hedge funds and positions of other categories of traders (*e.g.*, floor traders, merchants, manufacturers, commercial banks, dealers) for the same markets.

The study found that when new information comes to the market and creates some price movement, it is the commercial traders (such as oil companies, utilities, airlines) who react to it first. When they react by buying/selling/changing production, they want to hedge their action and they enter the futures markets to do that. The producers need to hedge and need someone to take the other side – that is where the large speculators play a role. The price changes that prompt large hedgers to alter their positions in the very short run eventually ripple through to large speculator participants who will change their positions in response. The hedgers request liquidity for their risk management and the speculators provide the liquidity.

The results also suggest that, on average, large speculators do not change their positions as frequently as other participants, primarily those who are hedgers. The staff also found no evidence of a link between price changes and MMT positions (conditional on other participants trading) in the natural gas market, and found a significantly negative relationship between MMT position changes and price changes (conditional on other participants trading) in the crude oil market. Hence, the report's conclusions show that speculative buying, as a whole, does not appear to drive prices up.

While speculation is critical to the markets, excessive speculation can be detrimental to the markets. Under the CEA, the concept of "excessive speculation" is based on trading that results in "sudden or unreasonable fluctuations or unwarranted changes in the price" of commodities underlying futures transactions. The CEA specifically makes it a violation of the Act to manipulate the price of a commodity in interstate commerce or for future delivery. The CEA does not make excessive speculation a *per se* violation of the Act, but rather, requires the Commission to enact regulations to address such trading (for example, through speculative position limits).

Pursuant to Section 4a of the Act, the Commission has utilized its authority to set limits on the amount of speculative trading that may occur or speculative positions that may be held in contracts for future delivery. The speculative position limit is the maximum position, either net long or net short, in one commodity future (or option), or in all futures (or options) of one commodity combined, that may be held or controlled by one person (other than a person eligible for a hedge exemption) as prescribed by a DCM and/or by the Commission. Moreover, CEA Section 5(d)(5) requires that an exchange, "[t]o reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month . . . shall adopt position limitations or position accountability for speculators, where necessary and appropriate."

All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits – and many financial futures and options are as well. With respect to such exchange spot month speculative position limits, the Commission's guidance specifies that DCMs should adopt a spot month limit of no more than one-fourth of the estimated spot month deliverable supply, calculated separately for each contract month. For cash settled contracts, the spot month limit should be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or underlying commodity's price.

With respect to trading outside the spot month, the Commission typically does not require speculative position limits. Under the Commission's guidance, an exchange may replace position limits with position accountability for contracts on financial instruments, intangible commodities, or certain tangible commodities. If a market has accountability rules, a trader – whether speculating or hedging – is not subject to a specific limit. Once a trader reaches a preset accountability level, however, the trader must provide information about his position upon request by the exchange. In addition, position accountability rules provide an exchange with authority to restrict a trader from increasing his or her position.

Finally, in order to achieve the purposes of the speculative position limits, the Commission and the DCMs treat multiple positions held on a DCM's market that are subject to common ownership or control as if they were held by a single trader. Accounts are considered to be under common ownership if there is a 10 percent or greater financial interest. The rules are applied in a manner calculated to aggregate related accounts.

Violations of exchange-set or Commission-set limits are subject to disciplinary action, and the Commission, or a DCM, may institute enforcement action against violations of exchange speculative limit rules that have been approved by the Commission. To this end, the Commission approves all position limit rules, including those for contracts that have been self-certified by a DCM.

It is clear that speculation is an important component of the futures markets, but there is a point when excessive speculation can be damaging to the markets. As a result, the CFTC closely monitors the markets and the large players in the markets, in addition to position and accountability limits, to detect potentially damaging excessive speculation and potential manipulative behavior.

CFTC Budget

Sufficient resources for the agency must accompany these legal and regulatory tools described in order for the Commission to adequately protect these markets from wrongful conduct. The budget that funds the CFTC's operating divisions, its technology and surveillance operations, and other support staff, is approximately $98 million for the current fiscal year (FY). The FY 2008 President's Budget request for the CFTC is for an appropriation of $116 million and 475 staff – an increase of approximately $18 million and 17 staff over the FY 2007 continuing resolution appropriation.

We are grateful for the Administration's recognition of the need for increased funding for our agency. The FY 2008 Budget request is a good down payment in an effort to reverse a recent declination in resources at the Commission, but it is, in perspective, a small recognition of the challenge we face.

Since the CFMA was enacted, there has been a seven-fold increase in the rate of new product listings by U.S. exchanges. Nine new DCMs and nine new DCOs have been approved by the CFTC. Electronic trading has soared to approximately 60 percent of total volume this year, and that percentage is steadily increasing. The competition, product innovation, and increasing use of technology fostered by the CFMA meant exponential growth in the futures and option markets, especially during the last few years. It has also meant a continuing evolution of these markets in the form of new trading venues, new trading strategies, new risk management tools, and new customers.

During this period of unprecedented growth for the futures industry, however, the CFTC's resources have been steadily diminishing. The CFTC needs additional staff in almost every program area and currently operates with a staffing numbers at an historic low. This historic low is contrasted by the increase in trading volume, trading platforms, product numbers and complexity, and cross-border business. To say the least, Commission employees are stretched. We have the resources to carry out the Commission's mission on a daily basis by asking more of staff and deferring critical technological needs and other programs, but the CFTC cannot continue on this path much longer.

Technology is critical to enable our professional staff to adequately oversee the markets. However, budget constraints have required the Commission to put new systems development initiatives and hardware and software purchases on hold. For example, Commission investment in technology, as a percentage of total budget, has fallen from approximately 10 percent to around seven percent. This trend is unsustainable given that so much of the growth in the futures industry is directly attributable to investments in technology. It is important that the Commission not be overwhelmed by the technologically innovative industry we regulate.

Conclusion

In summary, the Commission takes very seriously its Congressional mandate to protect the public and market users from manipulation, fraud, and abusive practices. The proper regulation of the nation's energy markets is one of the most significant issues facing this Commission. Energy prices discovered on these markets greatly impact our economy and every American – ranging from residential consumers to main street businesses to Wall Street firms. The CFTC appreciates the opportunity to assist Congress in examining and appropriately adjusting the Commission's authority in this area. Additionally, the Commission remains committed to collaborating with FERC to ensure that the energy markets are free from manipulation. I am grateful to testify today and look forward to answering any questions Committee members have on these pertinent and important matters.