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Testimony

Written Testimony of Acting Chairman Walter Lukken Before the Senate Committee on Homeland Security and Governmental Affairs

June 24, 2008

Chairman Lieberman, Ranking Member Collins, and other distinguished Members, thank you for inviting me to testify before this Committee on the role, responsibilities, and resources of the Commodity Futures Trading Commission (Commission or CFTC).

During the last few years, the futures markets have changed dramatically in size and complexity, experiencing 500 percent growth in both volume and products listed. Once member-owned and dominated by open-outcry trading, today exchanges are technology-driven corporations that primarily trade electronically, 24 hours a day, all around the globe. Approximately $5 trillion of notional transactions flow through these U.S. exchanges and clearing houses daily. This description alone would make the oversight of these markets a challenge for regulators. But add to it the sub-prime crisis, record energy and agricultural commodity prices, the influx of financial funds in futures, and historic low staffing levels at the CFTC, and it is clear that these are challenging times for this agency.

Recent substantial increases in the price of crude oil and other commodities have had a significant impact on American consumers and have put considerable strain on U.S. households. These issues are a matter of intense focus at the Commission due to the key role that futures markets play in the price discovery process. The CFTC shares the concerns of Americans and Congress, and we are committed to ensuring that our nation's futures markets operate fairly and efficiently, and that the prices of commodities, including crude oil, are determined by the fundamental forces of supply and demand, rather than abusive or manipulative practices.

The CFTC recognizes that these markets and their participants have evolved significantly in the last several years. Concerns have been raised recently regarding the role of speculators and index traders in the commodity markets. As prices have escalated, the CFTC has pursued an active agenda to ensure that the commodity futures markets are operating free of distortion as the agency looks to better understand the implications of these structural market developments. The Commission has undertaken several initiatives directed to enhancing the oversight of the energy and agricultural markets. These initiatives fall into five broad categories: 1) Increasing Information and Transparency, 2) Ensuring Proper Market Controls, 3) Continuing Aggressive Enforcement Efforts, 4) Improving Oversight Coordination, and 5) Seeking Increased Funding.

1) Enhancing Information and Transparency.

The proper oversight of markets requires transparency. Market regulators must receive the necessary information to conduct surveillance of market activity, study long-term financial trends, and evaluate policy changes as circumstances evolve. The backbone of the CFTC's market surveillance program is the large trader reporting system, through which the CFTC receives daily data showing all large traders' futures and options positions in the markets. This information enables the CFTC's surveillance economists to oversee all traders of size to ensure that no one is attempting to manipulate the futures markets. This amount and detail of trade data collected and analyzed at the CFTC is unprecedented among financial regulatory agencies.

As markets have become electronic and global, the CFTC has been working to expand and enhance its technology and trade data collection to accommodate these trends. Last spring, the CFTC announced a major technology purchase that will modernize our trade practice surveillance system to enhance basic trade surveillance and permit nearly real-time analyses of all trading activity. Investments in technology are critical for the CFTC to sort through the millions of pieces of information generated by these electronic markets daily.

The CFTC is also working to increase the amount and quality of the trader data we receive from the markets. In late May, the CFTC announced an agreement with the U.K. Financial Services Authority (FSA) to expand the trader data received from ICE Futures Europe on its cash-settled light sweet crude oil contract that settles off the NYMEX benchmark crude oil contract. When first listed in 2006, this linkage between the two contracts caused the Commission and its surveillance staff to be concerned that regulators would not be able to observe the entirety of a trader's position in both markets. Once the surveillance issue was identified, the CFTC worked with its foreign counterpart, the FSA, to share large trader data for these linked contracts to ensure that traders were not gaming one market to influence the other. At that time, the CFTC's agreement with the FSA provided the CFTC with weekly trader information, and daily information in the final trading week, to facilitate the ability of the CFTC and FSA to oversee trading in these related contracts.

Building on these efforts, the CFTC and FSA two weeks ago announced an expanded information-sharing arrangement, including: 1) providing daily large trader positions in the linked ICE Futures Europe crude oil contract, 2) extending trader information sharing to all contract months, 3) a near-term commitment to improve the identification of market end users to be completed within two months, 4) improved formatting so trading information can be seamlessly integrated into the CFTC's surveillance system, and 5) CFTC notification when traders exceed NYMEX position accountability levels. This cross-border information sharing is unprecedented among global regulators.

The CFTC also has taken action to improve the transparency of index traders and swap dealers in the energy markets. There is public concern about the amount of index money flowing into the futures markets. Pensions, endowments, and other long-term investors increasingly are investing a portion of their portfolios in a broad mix of commodities in order to diversify their holdings and reduce volatility and risk. Unlike traditional speculative trading by hedge funds and other managed money, index investors are typically non-leveraged entities utilizing a long-term buy–and-hold strategy. Most of this type of investment comes through major Wall Street swap dealers that sell their clients broad exposure to the commodity markets through an over-the-counter commodity index contract. Swap dealers then are exposed to commodity price risk as a result of aggregating these transactions and must utilize the futures markets to manage their own remaining residual risk. This "netting out" of risk by swap dealers before coming to the futures markets makes it difficult for regulators to determine the total amount of index trading occurring in the energy markets.

As a result, the Commission decided to issue special calls for information about commodity index trading, principally to swap dealers through whom most of this trading takes place in the over-the-counter (OTC) market. Some market commentary has pointed to long-only index trading as part of the reason for the sharp increases in energy prices. Through its large trader reporting system, the Commission has highly accurate information on all swap dealer positions in all regulated U.S. futures markets, including energy futures markets. However, swap dealers' futures positions can represent hedges of very complex "books" of many different types of OTC derivative and cash transactions. Therefore, swap dealers' futures positions do not necessarily correspond accurately with the amount of index trading that is occurring in the OTC market. In order to better understand the extent and possible impact of index trading, the Commission has issued special calls to swap dealers requiring them to provide information on commodity index transactions.

After analyzing this data, the Commission and its staff will provide a report to Congress by September 15, 2008 regarding the scope of commodity index trading in the futures markets and recommendations for improved practices and controls, should they be required.

2) Ensuring Proper Market Controls.

Last fall, the Commission announced its intention to address the mounting regulatory concerns surrounding exempt commercial markets that trade over-the-counter energy products. The Commission held a public hearing and worked with Congress to enact legislation as part of the Farm Bill requiring exempt commercial markets that trade contracts linked to regulated U.S. futures contracts to provide the CFTC with large trader reports and impose position and accountability limits on such products. Congress and this agency believed that these authorities were necessary to protect the regulated energy marketplace.

As noted earlier, linkages between contracts are not purely a domestic occurrence but also happen across international borders. Most energy and agricultural commodities are global commodities operating in a global marketplace, and the U.S. futures markets have been facing the challenges of cross-border trading and regulation for many years.

For more than a decade, the CFTC has worked to develop international regulatory networks, to increase international cooperation, and – most importantly – to maintain and improve oversight of U.S. futures markets in the face of increasing globalization. Over the years, the CFTC has developed a mutual recognition process that strikes the balance between the need for U.S. regulators to maintain confidence in the functioning and integrity of our markets, and the acknowledgement that the increased globalization of commodity markets requires international cooperation and coordination.

With this balance in mind, the CFTC last week announced modifications to its Foreign Board of Trade process. After consultation with the British FSA, the CFTC conditioned ICE Futures Europe's direct access to U.S. customers on implementation of position and accountability limits on its linked crude oil contract. In addition, ICE Futures Europe will adopt hedge exemption requirements similar to those in the U.S. and report any violations of those requirements to the CFTC. The CFTC has amended ICE Futures Europe's direct access letter to reflect this change. The CFTC will also require other foreign exchanges that seek such direct access to provide the CFTC with comparable large trader reports and to impose comparable position and accountability limits for any products linked with U.S. regulated futures contracts. This combination of enhanced information data and additional market controls will help the CFTC in its surveillance of its regulated domestic exchanges while preserving the benefits of a mutual recognition program that has enabled proper global oversight over the last decade.

The amended direct access letter also formalizes the recently announced information-sharing agreement between the CFTC and the FSA by requiring ICE Futures Europe to provide the CFTC with detailed market information, equivalent to U.S. standards for market surveillance, as a condition of receiving direct access to U.S. customers. The CFTC will incorporate this new data into the CFTC's Commitments of Traders Report, which is a weekly report categorizing traders and positions.

The Commission's staff intends to apply these new direct access conditions to any future requests by foreign exchanges for direct access to U.S. customers, where the exchange in question lists a contract that settles against contracts listed on any U.S. exchange. These revisions to the foreign board of trade program will provide the CFTC with additional oversight tools to monitor linked contracts. This combination of enhanced trading data and additional market controls will help the CFTC in its surveillance of regulated domestic exchanges, while preserving the benefits of our international mutual recognition program, which has permitted cross-border oversight of global markets over the last decade.

3) Continuing Aggressive Enforcement Efforts.

During these turbulent market conditions for crude oil, the environment is ripe for those wanting to illegally manipulate the markets and, as a result, the Commission has stepped up its already aggressive enforcement presence. In late May, the Commission took the extraordinary step of disclosing that in December 2007, its Division of Enforcement launched a nationwide crude oil investigation into practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivatives contracts. Although the Commission conducts its enforcement investigations in full confidentiality, today's unprecedented market conditions and the desire to maintain public confidence justified disclosing the existence of this investigation.

Since December 2002 to the present time, the Commission has filed a total of 39 enforcement actions charging a total of 64 defendants with violations involving the energy markets. The agency has assessed almost half a billion dollars in civil monetary penalties in settlement of these enforcement actions. The Commission also has achieved great success in this area by working cooperatively with the Department of Justice on over 35 criminal actions concerning energy market misconduct. Strong enforcement is imperative during this time.

4) Improving Oversight Coordination.

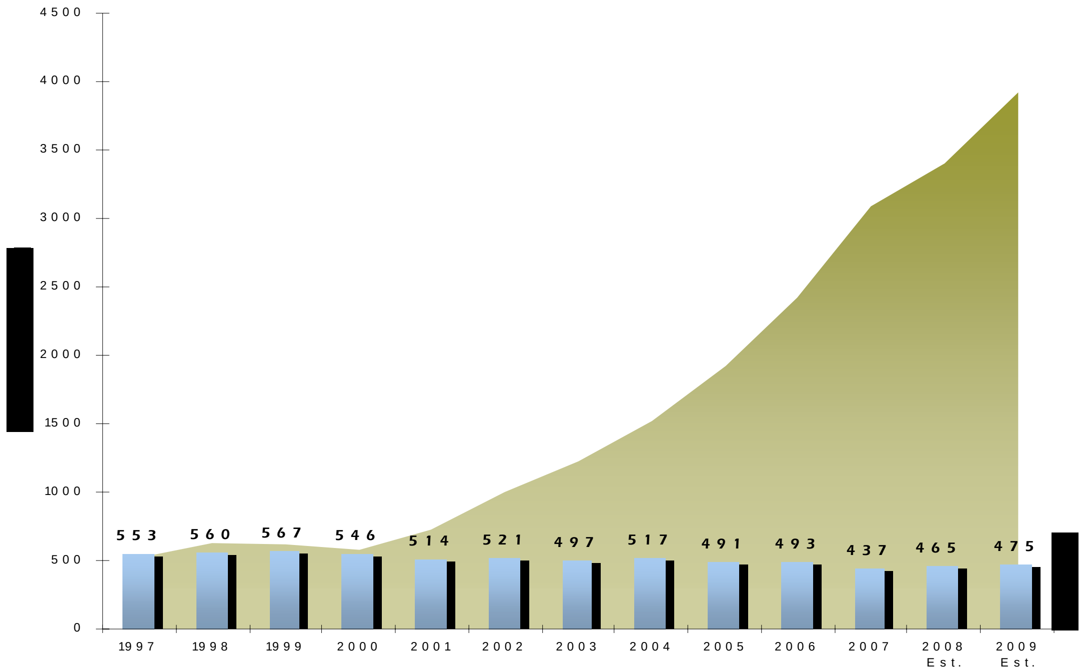
Given the CFTC's size and the enormity of the global marketplace, the CFTC must engage others in government as we seek to meet our important mission. Last week, the CFTC announced the formation of a CFTC-led interagency task force to evaluate developments in the commodity markets. The task force – which includes staff representatives from the CFTC, Federal Reserve, Department of the Treasury, Securities and Exchange Commission, Department of Energy, and Department of Agriculture – is examining investor practices, fundamental supply and demand factors, and the role of speculators and index traders in the commodity markets. It is intended to bring together the best and brightest minds in government to aid public and regulatory understanding of the forces that are affecting the functioning of these markets. We convened the first meeting last week and will strive to complete this work quickly and make public the results.

The CFTC also recently hosted its second international enforcement conference – a two day event focusing on global trading in the energy markets with senior enforcement officials from 10 countries. Our goal was to enhance the ability of the CFTC and its fellow regulators to detect and deter misconduct affecting commodity prices in the energy sector, and I am confident that it was a success that will bear the fruit of coordinated international enforcement for manipulation.

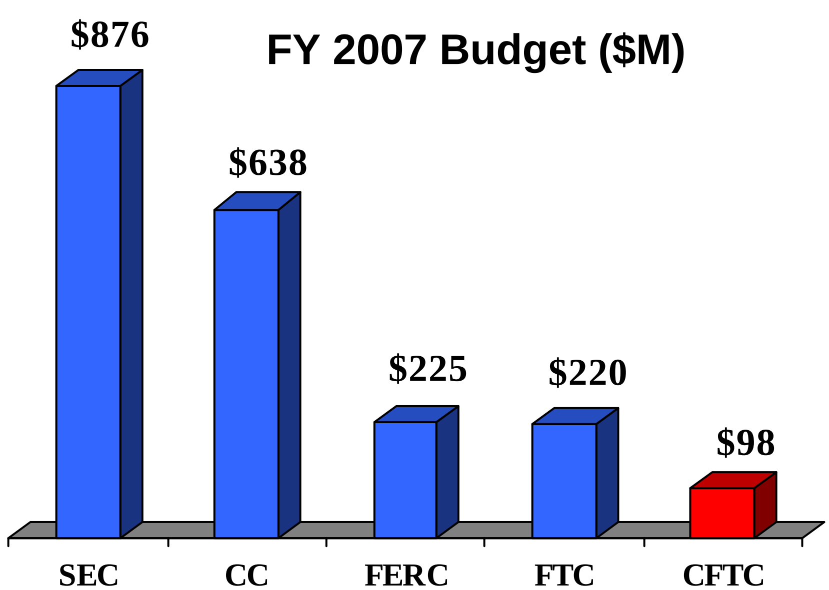
5) Seeking Increased Funding.

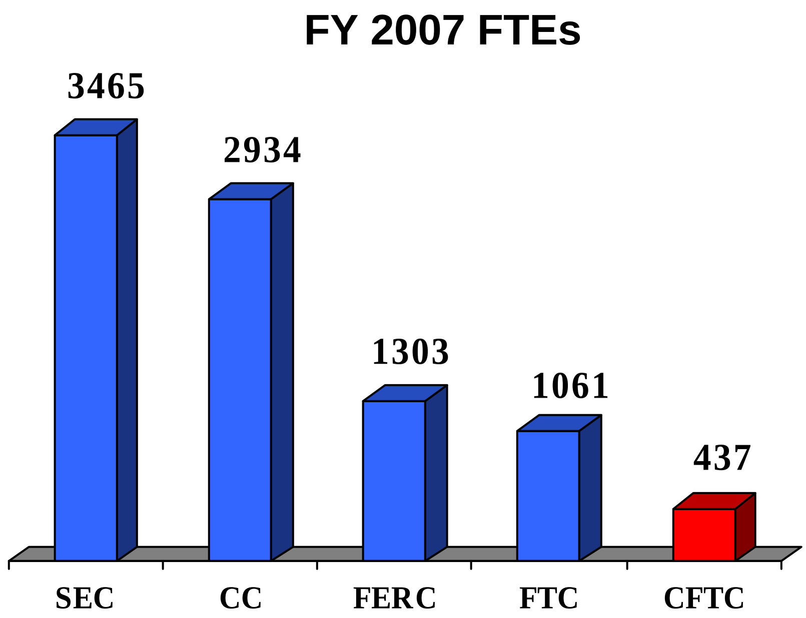
If the CFTC sounds busy, it is—especially given that the agency's staffing levels are near record low numbers. Since the CFTC opened its doors 33 years ago, the volume on futures exchanges has grown 8,000 percent while the CFTC's staffing numbers have fallen 12 percent. The following chart shows the exponential growth in contract volume, compared to CFTC staff numbers.

Growth in Volume of Futures & Option Contracts Traded & CFTC Staffing Levels



The CFTC's resources simply have not kept pace with the growth of the markets and the growth of similar financial regulators. As you can see, the CFTC lags other comparable agencies in funding levels by substantial margins. This agency's lack of funding over the course of many years has had a negative impact on our staffing situation, rendering it unsustainable for the long run.





The CFTC is a small agency doing an extraordinary job under difficult circumstances. The dedicated and skilled individuals at the CFTC are working tirelessly to ensure the integrity of the markets. However, as the agency embarks on new authorities and initiatives in order to respond to changing market conditions, it is imperative that the CFTC receive additional funding.

The CFTC is in the midst of implementing its new Farm Bill authorities, which require many programmatic changes and plain old hard work from a staff that is already under significant strain. Additionally, the agency's staff is racing to implement the many recent agency initiatives I outlined earlier in my testimony. Recall as well that our employees are also full-time regulators, charged with overseeing these markets each and every day, upholding the agency mission to safeguard the futures markets. Given our staffing numbers, the agency is working beyond its steady state capacity and is unable to sustain the current situation for much longer without being forced to make Hobson's choices about which critical projects should be completed and which ones will be delayed. And while we welcome discussions of any appropriate and necessary legislative or agency changes, our agency is clearly unable to accommodate additional tasks at our current resource and personnel level.

Last Tuesday, I testified at a joint hearing of the Senate Appropriations and Agriculture Committees to support the Commission's request for additional appropriations from Congress. In making this request, the Commission was mindful of the need to maintain fiscal restraint in appropriations and the competing needs of other parts of the Federal Government. However, we believe that the proposed funding level of $157,000,000 is the appropriate level of resources required to fulfill our immediate responsibilities. The increase will restore staffing to a level last sustained almost two decades ago when market volume, innovation, and complexity were significantly less than today and when the agency did not yet have to face the expanded workload brought on by globalization of the marketplace and the emergence and widespread use of derivatives and hedge funds. This of course means the Commission is now doing much more with less and continues to deliver a good return on investment for the American taxpayer. The Commission's ratio of workload to resources has always been lean compared to other financial regulators. But we have reached our limit and cannot uphold our mission without immediate additional resources.

In summary, I want to thank the Committee for inviting me to testify today. The Commission shares the Committee's concern for current conditions in the energy markets and for the effects of high crude oil and gas prices on American consumers, workers, and businesses. These are difficult times in the futures markets, and the Commission recognizes the need to respond accordingly. As I stated in my earlier testimony – and it bears repeating given the challenges of the last several weeks – I am deeply proud of our highly skilled and productive staff. This small Federal agency is working hard to protect the public and the market users from manipulation, fraud, and abusive practices in order to ensure that the futures markets are working properly.

Thank you for the opportunity to appear before you today on behalf of the CFTC. I would be happy to answer any questions you may have.