Commodity Futures Trading Commission
Office of External Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Testimony

Written Testimony of Acting Chairman Walter Lukken Before the House Appropriations Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies

July 10, 2008

Chairwoman DeLauro, Ranking Member Kingston, and other distinguished Members, thank you for inviting me to testify before this Subcommittee about the Commodity Futures Trading Commission's (CFTC or Commission) FY09 budget request and the role of the agency in overseeing the dynamic futures and options markets.

The CFTC's mission is twofold: 1) protecting the public and market users from manipulation, fraud, and abusive practices and 2) promoting open, competitive and financially sound markets for commodity futures and options. These mandates are crucial because prices in the futures markets impact the cost of a loaf of bread, the price of a gallon of gas, and the interest rate on a student loan. If the futures markets fail to work properly, all consumers are impacted.

Futures markets help participants efficiently bring supply and demand expectations from many sources to a central and transparent location to "discover" prices for a given commodity. Akin to a thermometer that reflects - rather than sets - temperatures, properly functioning futures exchanges are the messenger for prices. Lately these markets have been reflecting prices that are putting a considerable strain on American families and businesses. It is this agency's mission to ensure that the futures markets are working properly and that prices are reflecting economic factors rather than manipulative forces.

Evolving with Change

The futures markets have changed dramatically in the last decade. Member-owned exchanges conducting open-outcry have largely been replaced by technology-driven corporations that trade electronically all around the globe. Approximately $5 trillion of notional transactions flow through these U.S. exchanges and clearing houses daily.

Since 2000, volume on U.S. exchanges has grown six-fold as traders increasingly seek the price certainty and clearing benefits of the regulated futures markets.

The growth in the regulated marketplace has been scrutinized lately—and appropriately so—as prices in crude oil and agricultural commodities have risen to historic levels. Specifically, concerns have been raised recently regarding the role of speculators and index traders in commodity markets. Speculation has played a crucial role in the functioning of the U.S. futures markets since their founding more than 150 years ago. Without speculators, the futures markets would not be able to operate properly. Commercial participants cannot hedge their activities without someone willing to take the other side of the transaction. In futures markets, this counterparty role is often taken by speculators. The liquidity provided by speculators has tended to lower the costs of hedging to the benefit of commercial participants in the markets.

Nevertheless, this agency recognizes that all market participants, including speculators, can detrimentally affect the functioning of the markets. Accordingly, the Commodity Exchange Act requires all traders of size to report their futures positions to the CFTC daily. This information enables our surveillance economists to monitor large traders to ensure that no one is attempting to manipulate the futures markets. The amount and detail of trade data collected and analyzed at the CFTC is unique among financial regulatory agencies and this system has proven to be extremely effective in the proper policing of this market.

As the futures markets have changed, the CFTC has evolved to meet new challenges. In light of the recent market developments and the impact of high prices on consumers, the CFTC has embarked upon a series of initiatives and unprecedented steps to ensure greater transparency, implement tighter controls, and gather more energy market information. For example, the Commission recently announced several energy initiatives, including: (1) an agreement with the United Kingdom Financial Services Authority (FSA) to expand information-sharing concerning energy commodity contracts with U.S. delivery points that trade on both the New York Mercantile Exchange and ICE Futures Europe in London, as well as the imposition of position limits and accountability levels on these products equivalent to U.S. standards; (2) a call for additional information from swaps dealers regarding their index trading and a review of whether additional controls or classifications for these traders are needed; and (3) the existence of an ongoing seven-month nationwide crude oil investigation.

The CFTC is committed to ensuring that our nation's futures markets operate fairly and efficiently, and that the prices of commodities are determined by the fundamental forces of supply and demand, rather than abusive or manipulative practices. Regulatory evolution and thoughtful responses to market conditions are keys to effective market oversight in a dynamic and challenging global marketplace. The CFTC and its regulatory approach have evolved along with the futures markets, and the agency has pursued its mission while operating at historic low staffing levels. This is clearly a challenging time for the CFTC and I believe the agency has risen to the occasion – but we simply cannot sustain the current workload – let alone what is likely in the future – under our current budgetary limitations.

Recent Timeline

During the last year, the Commission has worked to address the structural changes occurring in these markets, which have been brought on by globalization, electronic trading, and other factors. Using the flexibility of the agency's principles-based regulatory framework, the agency is evolving with the markets and responding to structural changes. I'd like to walk you through that evolutionary timeline.

July 2007

- After an investigation spanning several months, the CFTC charged hedge fund Amaranth and its former head energy trader, Brian Hunter, with attempted manipulation of the price of natural gas futures on the New York Mercantile Exchange on February 24 and April 26, 2006.

August 2007

- The Commission announced that it filed and settled charges against Marathon Petroleum Company for attempting to manipulate the crude oil market. The Commission must complement robust market surveillance with a strong enforcement effort. The agency's Division of Enforcement has been extremely effective in areas as diverse as internet fraud, foreign currency scams, energy market manipulation and hedge fund fraud.

September 2007

- In September 2007, the Commission convened a public hearing to examine the oversight of energy trading on Exempt Commercial Markets (ECMs). Recognized by Congress in 2000, ECMs increased competition and lowered costs for derivatives trading, but over time, certain energy contracts offered on ECMs evolved to function as virtual substitutes for contracts listed on regulated exchanges, with tight correlation and linking of prices and participants. This evolution required the Commission's regulation of these markets to evolve in kind. During the September hearing, Commission staff, exchanges, ECMs, industry groups, and consumer organizations testified before the Commission in a productive debate.

October 2007

- Based on the agency's ECM hearing, in October, the Commission presented a report to Congress detailing the Commission's findings and recommendations regarding these energy markets. The report also recommended the creation of a new Energy Markets Advisory Committee to further examine energy issues.

- The Commission convened a meeting of its Global Markets Advisory Committee focusing on issues affecting new exchanges and clearing structures in the U.S., and the European Union's ongoing review of commodity derivatives regulation and possible changes to its regulatory approach.

- The CFTC's Division of Enforcement hosted its first annual international enforcement conference focused on commodity market manipulation. The two-day conference brought international regulators together to examine trends in the on-exchange, cash, and over-the-counter commodity markets. Given the global nature of the futures markets, it is crucial for regulators to work cooperatively across borders to achieve the shared goals of detecting and deterring misconduct affecting commodity markets.

- The agency continued its aggressive enforcement efforts and announced in late October that BP would pay a total of $303 million in sanctions to settle charges of manipulation and attempted manipulation in the propane market. Since December 2002, the Commission has filed 41 enforcement actions charging a total of 66 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.

November 2007

- After sending the agency's ECM recommendations to Congress, during the fall and winter of 2007 and into early 2008, Commission staff provided technical assistance to Congressional staff as they considered CFTC reauthorization legislation.

December 2007

- The agency convened an Agricultural Advisory Committee meeting to examine agriculture market issues. Commissioner Michael Dunn led this hearing that involved industry discussion of changes in price discovery and market structure, the role of speculation in agricultural futures markets, and the role of agricultural over-the-counter markets.

February 2008

- The CFTC and the China Securities Regulatory Commission (CSRC) announced that the agencies agreed to hold regular meetings to promote enhanced cooperation and collaboration. These meetings will be designed to promote investor protection, market integrity, and the supervision of derivatives trading occurring on a cross-border basis between China and the U.S.

- Following up on the agency's Fall 2007 ECM report to Congress, the CFTC announced the creation of its new Energy Markets Advisory Committee (EMAC). The EMAC provides a public forum to examine emerging issues related to the energy markets and the CFTC's role in these markets under the Commodity Exchange Act. It is charged with conducting public meetings, submitting reports and recommendations to the CFTC, and serving as a vehicle for discussion on matters of concern to exchanges, firms, end users and regulators regarding energy markets and their regulation by the CFTC.

March 2008

- The CFTC and the Securities Exchange Commission signed a ground-breaking mutual cooperation agreement to establish a closer working relationship between the agencies. The agreement establishes a permanent regulatory liaison between the agencies, provides for enhanced information sharing, and sets forth several key principles guiding their consideration of novel financial products that may reflect elements of both securities and commodity futures or options. As innovation blurs financial sector lines and markets evolve, this agreement provides regulatory synergies between the agencies for the benefit of the public.

April 2008

- In early 2008, agriculture commodity prices, broadly, began trading at historically high levels. On April 22, following up on the agency's December Agriculture Advisory Committee meeting, the CFTC convened a day-long public roundtable to examine the extraordinary times in the agricultural markets. The agency brought together a broad cross-section of agricultural market participants in an effort to share experience and help to form a collective understanding of what is occurring. More than 2,800 individuals watched the forum over the Internet. The topics discussed included price discovery, the role of speculators, index funds and hedgers, transparency, hedging, the role of agriculture swaps and risk management tools, the role of margin and the clearing system in the futures markets, and credit availability.

May 2008

- After years of work and bipartisan efforts, Congress enacted the CFTC reauthorization legislation, as part of the Farm Bill, which makes several improvements to the agency's statutory authorities. Specifically, the legislation:

    - Closes the so-called "Enron Loophole" to require, for ECMs that trade contracts linked to regulated U.S. futures contracts or that otherwise perform a significant price discovery function, that the CFTC be provided with large trader reports and that the ECM impose position and accountability limits on such products.

    - Increases penalties for manipulation.

    - Clarifies anti-fraud authority for principal to principal energy trades.

    - Clarifies retail foreign currency fraud authority.

    - Reauthorizes CFTC through 2013.

- A week after reauthorization enactment, the CFTC announced multiple energy market initiatives, including:

    - Confirmation of a six-month ongoing national crude oil investigation.

    - An agreement to receive enhanced data from ICE Futures Europe in London on certain of its crude oil markets to match our current information requirements for domestic exchanges. This allows the CFTC to see U.S. and foreign participants in the London market that the CFTC would not normally oversee.

- Requiring more detailed information from index traders and swaps dealers in the futures markets, including the energy markets, and reviewing whether classification of these types of traders can be improved for regulatory and reporting purposes.

June 2008

- In the first week of June, the CFTC announced several policy initiatives aimed at addressing agricultural futures markets concerns that were raised at its April 22nd roundtable, including, among other things:

    - The CFTC's ongoing investigation of the February/March 2008 price run-up in the cotton futures markets.

    - Requiring more detailed information from index traders and swaps dealers in the futures markets, including the agriculture markets, and reviewing whether classification of these types of traders can be improved for regulatory and reporting purposes.

    - A Commission vote to withdraw proposed rulemakings to increase the Federal speculative position limits on certain agricultural futures contracts and create a risk management hedge exemption from the Federal speculative position limits for agricultural futures and option contracts.

- The initiatives announced in late May and June that were designed to improve the transparency of index traders and swaps dealers in the energy and agriculture markets require further explanation, as they represent a critical piece of the agency's ongoing efforts to ensure the proper functioning of the futures 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 swaps dealers that sell their clients broad exposure to the commodity markets through an over-the-counter (OTC) commodity index contract. After aggregating these transactions, swaps dealers then face a net commodity price risk and must utilize the futures markets to manage their own remaining exposure. This "netting out" of risk by swaps 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 swaps dealers through whom most of this trading takes place in the 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 swaps dealer positions in all regulated U.S. futures markets, including energy futures markets. However, swaps dealers' futures positions can represent hedges of very complex “books” of many different types of OTC derivative and cash transactions. Therefore, swaps 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 swaps dealers requiring them to provide information on commodity index transactions.

- In late June, the CFTC hosted its first EMAC meeting to examine the issue of transparency in the energy markets, as well as the role of index trading and energy trading on foreign boards of trade.

- The CFTC formed an interagency working group with the Federal Reserve, Treasury Department, Securities and Exchange Commission, Department of Energy, Department of Agriculture, Federal Trade Commission, and Federal Energy Regulatory Commission to study investor practices, fundamental supply and demand factors, and the role of speculators and index traders in the commodity markets. The group has already met and is working expeditiously toward completing its public report.

- Following up on the success of our first international enforcement conference in October 2007, in June 2008, the CFTC hosted its 2nd annual international regulators enforcement meeting in Washington DC with 10 different nations participating to discuss on-going manipulation cases and practices.

- The CFTC announced further modifications to its direct access process for foreign boards of trade. After consultation with the U.K. FSA, the CFTC conditioned ICE Futures Europe’s direct access to U.S. customers on implementation of equivalent position limits and accountability levels on its linked crude oil contract. Pursuant to the further modifications, ICE Futures Europe also will adopt hedge exemption requirements similar to those in the U.S. and report any violations of those requirements to the CFTC. The CFTC staff has amended ICE Futures Europe’s direct access letter to reflect this change.

- Following up on the May-June energy and agriculture initiatives to get further information about index traders and swaps dealers in the futures markets, this month, the CFTC also announced it will report to Congress as soon as practicable, and no later than 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.

July 2008

- The CFTC announced that Commission staff has amended the May 27, 2007, “no-action relief letter” under which the Dubai Mercantile Exchange (DME) is permitted to make its electronic trading and order matching system available to DME members in the United States. The new conditions are designed to help the Commission carry out its market surveillance responsibilities and maintain the integrity of prices established on CFTC-regulated exchanges in light of the fact that the DME may list for trading a cash-settled contract that settles on the price of a contract traded on a CFTC-regulated exchange.

- CFTC is in the midst of implementing its the new authorities resulting from CFTC reauthorization – staff is currently drafting proposed rules for the ECM legislation and will meet the deadlines as outlined in statute.

- On July 15, the agency's Global Markets Advisory Committee, led by Commissioner Jill Sommers, will convene to get information from industry and market users regarding the risks and benefits of direct market access by customers trading on exchanges and whether there is a need for industry-wide guidance.

- On July 29, the agency's Agricultural Advisory Committee, led by Commissioner Michael Dunn, will meet to continue to develop solutions with the agricultural market participants to issues surrounding price convergence, margin requirements, financing, and alternatives to existing risk management tools.

Looking back at the CFTC's actions during the course of the year, both our agency and the marketplace we oversee are moving at an incredible pace. Based on our continual examination of futures industry issues, the CFTC is implementing a number of initiatives to tighten controls, increase transparency and improve the overall functioning of the markets. We have increased regulation and transparency of trading on Exempt Commercial Markets, and for Foreign Boards of Trade that have trading screens here in the U.S., and we are in the midst of bringing greater transparency to swaps dealers and institutional investors.

It is important to remember that the actions listed above are on top of the Commission's ongoing regular activities. For example, the Division of Enforcement continues to investigate and litigate violations of the CEA. The Division of Market Oversight continues to oversee exchange operations, examine the compliance programs of Self-Regulatory Organizations, review exchange rules, products and procedures, and most significant, conduct routine surveillance of the nation's futures markets during this extraordinary period. The Division of Clearing and Intermediary Oversight continues its audit and review programs directed at clearing houses and intermediaries, all in an effort to protect customers and assure financial integrity.

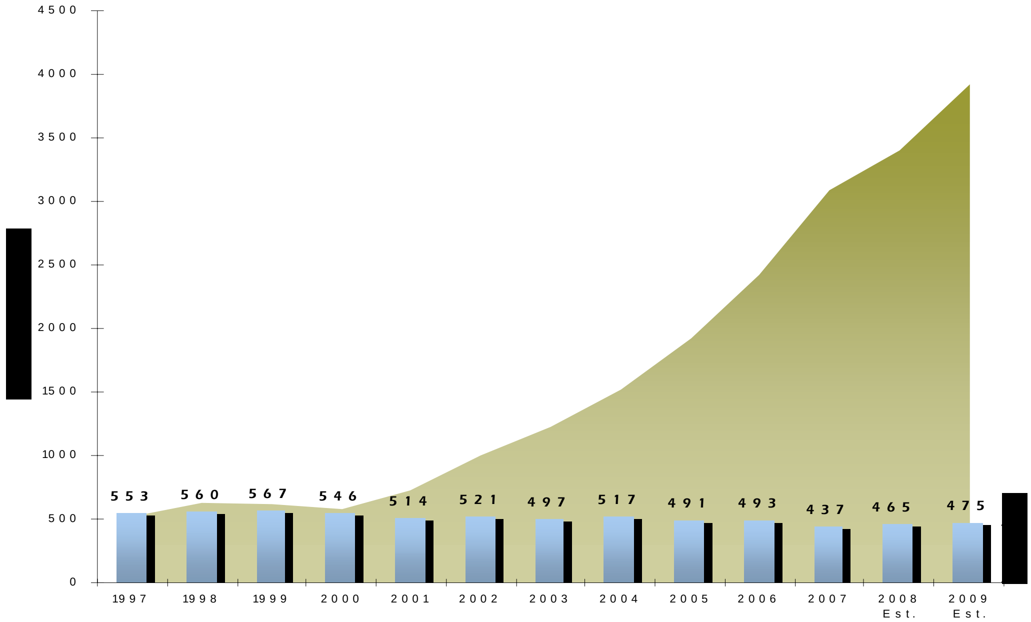
These efforts – both the daily work of overseeing the markets as well as new initiatives – are carried out each and every day by a Commission and staff dedicated to upholding the agency's mission of ensuring the integrity of the futures and options markets.

CFTC Funding

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.

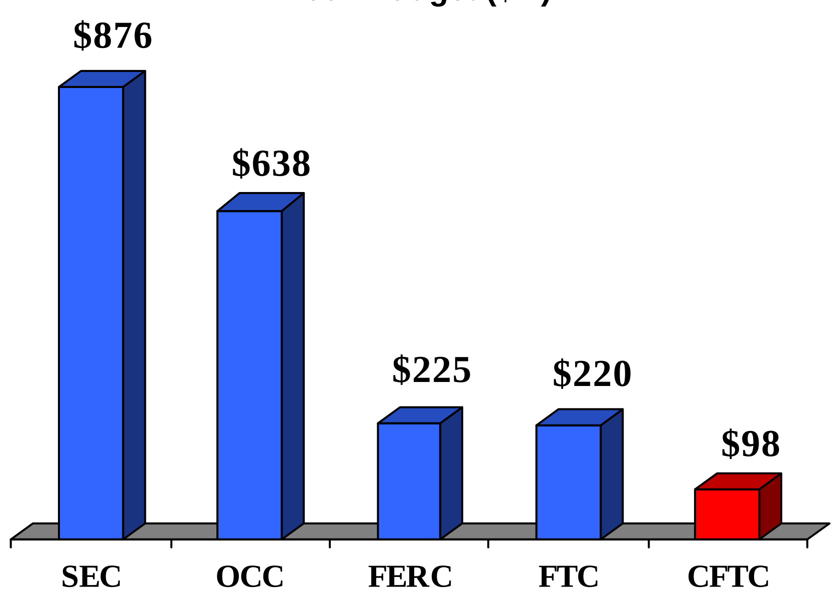
Growth in Volume of Futures & Option Contracts Traded

& CFTC Staffing Levels

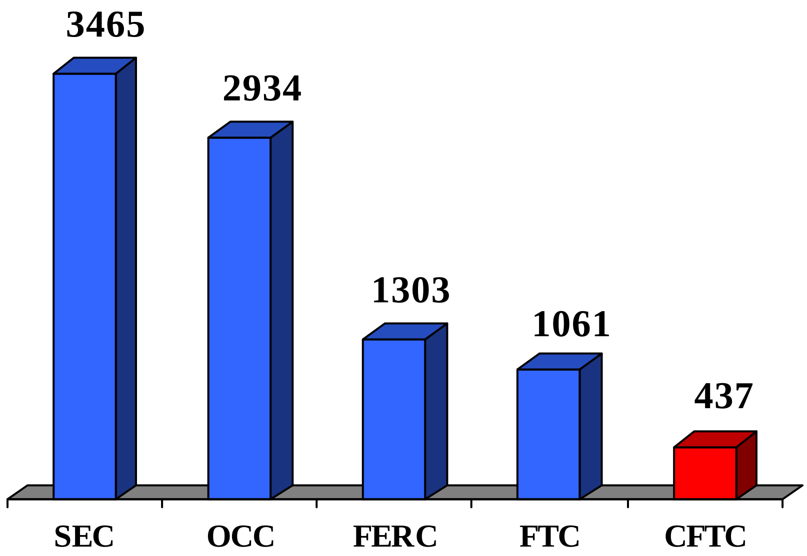


The CFTC's resources simply have not kept pace with the growth of the markets and the growth of similar financial regulators. As you can see in the following charts, the CFTC lags other comparable agencies in funding levels by substantial margins. This agency's lack of funding over the course of many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

FY 2007 Budget ($M)



FY 2007 FTEs



The agency appreciates the increased funding from Congress of about $111 million for FY 2008 – that funding is being put to use now on priority hiring and making long-overdue major technological investments. For example, 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 – funding will allow for the completion of this project more quickly. Investments in technology and personnel are critical for the CFTC to sort through the millions of pieces of information generated by these electronic markets daily.

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.

As you are aware, the Administration has proposed for the Commission a budget of $130,000,000 for FY 2009. The Commission is very appreciative of the budget proposal – which reinforces the reversal of an almost two-decade-long downward trend in real funding. The $130,000,000 is greatly needed to continue the implementation of the long-delayed information technology modernization initiative first begun in FY 2008, and enables us to take continued steps to address our staffing shortage. In addition, last month, this Subcommittee marked up a funding bill that included $135,000,000 for the agency for FY 2009, which is deeply appreciated. We recognize the overall tight budgetary situation and appreciate the funding levels above the President’s budget.

However, given these new authorities and the unprecedented market conditions of the day—conditions that could not have been anticipated when the FY 2009 budget was first formulated last summer—we welcome this hearing at a critical and opportune time. After reviewing the impact of recent initiatives and the projections associated with legislative changes, the Commission estimates it will require an additional $27,000,000 -

- above the President's FY 2009 budget of $130,000,000 and 475 FTEs -- for a total of $157,000,000 and 596 FTEs.

The additional $27,000,000 is comprised of $21,000,000 and 92 FTEs originally requested last September in our FY 2009 Budget Estimate submitted to Office of Management and Budget – and to Congress as required by the Commodity Exchange Act – as well as an additional $6,000,000 to undertake new responsibilities as mandated in the Farm Bill of 2008. In making this request, the Commission is 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.

In summary, I want to thank the Subcommittee for inviting me to testify today. The Commission shares the Subcommittee's concern about current conditions in the energy markets and over 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. 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.