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Mr. Chairman, Senator Dodd, and Members of the Subcommittee, I appear before you today in my capacity as Chief Economist of the Commodity Futures Trading Commission (CFTC), the federal government regulator of futures and futures options markets in the United States. The term "hedge fund" is not a term we use in our regulatory work at the CFTC. To the extent that any subsidiary fund within a hedge fund complex uses exchange-traded derivatives, the operator of that subsidiary fund and its advisor may be subject, under certain circumstances, to registration and reporting requirements under the Commodity Exchange Act, the statute administered by the CFTC.

In my testimony today I will address several topics. First, I will describe the role that hedge funds play in futures markets in general, and the role they play in commodity futures markets in particular. Second, I will briefly describe the surveillance methods used by the CFTC to monitor large traders, including many hedge funds, in order to ensure market integrity. Third, I will describe the financial safeguard system in place to ensure that the financial distress of a single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market. Lastly, I will describe the CFTC's oversight authority with respect to the operators of pooled investment vehicles trading commodity futures or options.

The Role of Hedge Funds in Futures Markets.

Futures markets serve an important role in our economy by providing a means of transferring risk from those who do not want it to those willing to accept it for a price. Traders who are trying to reduce their risks are called "hedgers," a group that typically includes those who have an underlying commercial interest in the commodity upon which the futures contract is written. Futures exchanges know from experience that the markets they host cannot exist with hedgers alone. In order for hedgers to reduce the risk they face in their day-to-day commercial activities, they need to trade with someone willing to accept the risk the hedger is trying to shed. Data from the CFTC's Large Trader Reporting System are consistent with the notion that hedge funds, and other professionally managed funds, are often the ones who facilitate the needs of hedgers.

CFTC large trader data also show that hedge funds and other professionally managed funds hold significant "spread" positions, that is, positions across related contracts. These spread positions are structured to speculate on relative price differences between contracts (e.g., prices for October delivery vs. prices for November delivery), and when structured as such, are unrelated to the overall level of futures prices. These spread trades play a vital role in keeping prices of related markets (and prices of related contracts within the same market complex) in proper alignment with one another. Hedge funds also add to overall trading volume, which contributes to the formation of liquid and well-functioning markets.

One notable development over the past five years has been the increased participation by pension funds, university endowments, hedge fund investors, and other financial institutions in futures markets for physical commodities. These institutions view commodities as a distinct "asset class" and have allocated a portion of the portfolios they manage, either directly or indirectly, into futures contracts tied to commodity indexes. The total investment in commodity-linked index products by pension funds, hedge funds and other institutional investors has been estimated by industry observers to exceed $100 billion. A significant portion of this amount finds it way into futures markets, either through direct participation by those whose commodity investments are benchmarked to a commodity index, or through participation by commodity index swap dealers who use futures markets to hedge the risk associated with their dealing activities.

The greater participation by funds and commodity index investors has raised questions by some market observers about whether their activity is distorting prices in commodity futures markets. These issues strike at the heart of what the futures markets are all about. Futures markets exist because they provide two vital functions for the marketplace: risk management and price discovery. The job of the CFTC is to ensure the integrity of these vital market functions and public confidence in them.

In that regard, some in the industry have urged greater transparency in the CFTC's Commitment of Traders Report (COT) by distinguishing among the market participants that currently comprise the category of "commercials" for each market. They argue that the current reporting system does not appropriately distinguish between traditional commercial activity and non-traditional commercial activity, such as that involving the hedging of commodity index exposure by swap dealers. Questions also have been raised as to whether the COT report should show professionally managed funds, including hedge funds, as a separate category, rather than include them with other non-commercial traders. On the opposing side, however, are those who argue that greater transparency may come at the cost of compromising the confidentiality of traders' proprietary information.

In the coming months, the CFTC will consider these issues in a deliberative fashion through a process that is fully transparent to the public.

Surveillance Methods Used by the CFTC to Monitor Large Traders—Including Hedge Funds.

The CFTC relies on a program of market surveillance to ensure that markets under CFTC jurisdiction are operating in an open and competitive manner, free of manipulative influences or other price distortions. The heart of the CFTC's market surveillance program is its Large Trader Reporting System. This system captures end-of-day position-level data for market participants meeting certain criteria. Positions captured in the Large Trader Reporting System make up 70 to

90 percent of all positions in a particular market. The Large Trader Reporting System is a powerful tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate the market. For surveillance purposes, the large trader reporting requirements for hedge funds are the same as for any other large trader.

Using the large trader reports, CFTC economists monitor futures market trading activity, looking for large positions and large trades that might be used to manipulate prices. Each day, for all active futures and option contract markets, surveillance staff members monitor the daily activities of large traders and key price relationships. In addition, CFTC market analysts maintain close awareness of supply and demand factors and other developments in the underlying cash markets through review of trade publications, government reports, and through industry and exchange contacts. The CFTC's surveillance staff routinely reports to the Commission on surveillance activities at weekly surveillance meetings.

In addition to the efforts of the Commission staff, each futures exchange is required under the Commodity Exchange Act to affirmatively and effectively supervise trading, prices, and positions, and the Commission examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfillment of this important responsibility. All of these efforts are reported upon regularly to the CFTC's commissioners. The Commission's reports on its rule enforcement reviews of the different futures exchanges are posted on our Website at www.cftc.gov.

Finally, the CFTC conducts an aggressive enforcement program that prosecutes and punishes those who break the rules. Nearly one-third of the CFTC's resources are devoted to its enforcement program. The punishment meted out as the result of enforcement proceedings deters would-be violators by sending a certain and clear message that improper conduct will be detected and will not be tolerated. The Commission has brought approximately 72 enforcement actions involving commodity pools and commodity pool operators in the last seven years. The defendants in these enforcement actions offered investments in what were advertised as hedge funds or commodity pools in which investor funds were misappropriated or misused, or where customers were solicited based upon false track records.

Hedge Funds and the Futures Industry's Clearing System.

The collapse of Long Term Capital Management in 1998 highlighted concerns about the risks potentially posed by a large hedge fund on the financial system as a whole. Within the futures industry, the clearinghouse affiliated with each exchange and the clearing member firms of each clearinghouse play a critical role in ensuring that the financial distress of any single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market.

All market participants must have their futures transactions, and the positions resulting from such transactions, cleared at a futures clearinghouse through a clearing member firm of that clearinghouse. Such clearing member firms must be CFTC-registered futures commission merchants (FCMs). FCMs are financial intermediaries that must adhere to CFTC-specified minimum net capital requirements.

Futures clearinghouses use a variety of financial safeguards to protect the clearing system from the financial difficulties of any firm that is part of that system. A clearinghouse's financial safeguard system involves multiple tiers. The first tier includes the margin money deposited by clearing member firms on behalf of their customers and their own proprietary accounts. The second tier may include the capital of the clearinghouse in excess of the working capital required for continuing clearinghouse operations. Clearinghouses also maintain guarantee funds that accrue value over time. If all of these funds are exhausted, many clearinghouses have the right to assess clearing members for unsatisfied obligations. Clearinghouses also hold credit lines to ensure that funds are immediately available in the case of an emergency. Finally, clearinghouses perform periodic risk evaluations of clearing member firms in an attempt to detect potential weaknesses in financial condition or risk controls. In addition, each clearing member firm has its own financial safeguards in place to protect itself from the financial distress of a customer—including a hedge fund customer.

The CFTC's Oversight Authority with Respect to Hedge Funds.

A hedge fund with positions in contracts under CFTC jurisdiction is a "commodity pool" and its operator or its adviser are required to register with the CFTC as a Commodity Pool Operator (CPO) or Commodity Trading Advisor (CTA), unless an exclusion or exemption from registration is available. Notably, the operators and advisors of commodity pools, but not the pools themselves, are required to register with the CFTC. Once registered, the CPO must comply with certain disclosure, reporting, and recordkeeping requirements and become subject to periodic examinations. Currently, there are approximately 1,800 CPOs and 2,600 CTAs registered with the CFTC.

The disclosure and financial reporting format for registered CPOs and CTAs is designed to ensure that prospective and actual participants in commodity pools receive all information that would be material to their decision to make, or maintain, an investment in a pool. To that end, at the point of sale, CPOs and CTAs are required to provide certain disclosures to prospective investors regarding the pool's investment program, principal risks factors, their conflicts of interests, and performance data and fees. Thereafter, CPOs must provide pool participants with an account statement at least quarterly and an annual report containing a financial statement, which must be audited by an independent public accountant and presented in accordance with Generally Accepted Accounting Principles (GAAP).

CFTC regulations provide a simplified regulatory framework for CPOs and CTAs under certain conditions. Many hedge funds are eligible for this simplified framework. The most significant relief is for pools that are offered only to "qualified eligible persons" who meet certain net worth and sophistication standards under CFTC Regulation 4.7.

CPOs and CTAs registered as such generally must be members of the National Futures Association (NFA), an industry self-regulatory organization. In practice, the CFTC has delegated many of its regulatory responsibilities in this area to the NFA, including the registration processing function, and review of disclosure documents and financial statements.

To this point, I have outlined what CFTC regulation involves. It is equally important to note the limits of that regulation. The CFTC does not prescribe the form of organization of pooled investment vehicles, nor does it impose limits on the fund's market risk appetite, the instruments that may be traded, the fees charged, or who may participate. Although the CFTC reviews financial statements to see that they include all required information and conform to applicable accounting standards, the review does not include an analysis of the transactions themselves.

This concludes my remarks. I look forward to your questions.