Testimony of

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Subcommittee on Oversight and Investigations

Concerning

"Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?"

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Mr. Chairman and members of the Subcommittee, my name is Tom LaSala and I am Senior Vice President and Chief Regulatory Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. NYMEX has been in the business for more than 135 years and is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC) both as a "derivatives clearing organization" and as a "designated contract market" (DCM), which is the highest and most comprehensive level of regulatory oversight to which a derivatives trading facility may be subject under current law and regulation.

On behalf of the Exchange, its Board of Directors and shareholders, I thank you and the members of the Subcommittee on Investigations and Oversight for the opportunity to participate in today's hearing on the question of "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?"

Overview

NYMEX is fully regulated by the CFTC, which by statute has long had exclusive jurisdiction over futures contracts, trading and markets. In addition to the CFTC's direct monitoring of futures trading**,** as a DCM, NYMEX has an affirmative statutory obligation to act as a self-regulatory organization, relying upon the standards set by statute and by

CFTC regulation and interpretation. Self-regulatory duties were voluntarily assumed by futures exchanges many years before the federal regulation of commodity markets. As an SRO, NYMEX routinely uses tools such as large trader reporting and position accountability and position limit levels to monitor and to police trading in our contracts.

A new statutory tier of trading facility, the exempt commercial market (ECM), was added to the CFTC's governing statute in 2000. The ECM is essentially exempt from substantive CFTC regulation and also has no explicit SRO duties by statute. In addition, to date, ECMs have not voluntarily assumed any SRO duties. As a result of market changes that were not anticipated in 2000, such as the effective linking of trading on unregulated venues with trading on regulated venues of competing products, certain ECMs now serve in a price discovery role and thus trigger public policy concerns and warrant a higher degree of CFTC oversight and regulation.

A recent CFTC report to Congress recommends that such contracts should be subject by statute to large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself. NYMEX strongly supports the CFTC's targeted and focused legislative proposals. The CFTC's recommended changes are also supported by the President's Working Group on Financial Markets.

Finally, Congress created the CFTC in 1974 and provided the new agency with exclusive jurisdiction over futures markets. Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation, a function which requires highly specialized skills, and the CFTC has developed such expertise. In subsequent reauthorizations, when Congress intended to create limited exceptions to that authority, it has always done so through express amendments of the CFTC's governing statue. Consequently, most observers have concluded that Congress did not intend to alter the CFTC's exclusive jurisdiction with the Energy Policy Act of 2005. The contrary interpretation now being pursued by Federal Energy Regulatory Commission (FERC) substantially harms futures markets by adding the cost and uncertainty of conflicting standards. It also severely undermines the ability of NYMEX and other regulated exchanges to carry out their SRO responsibilities.

NYMEX'S Role and Responsibilities as a DCM

NYMEX operates its trading facility as a designated contract market. As the benchmark for numerous energy prices around the world, trading on NYMEX is transparent, open and competitive and fully regulated by the CFTC. NYMEX does not trade in the market or otherwise hold any market positions in any of its listed contracts and, being price neutral, does not influence price movement. Instead, NYMEX provides trading forums that are structured as pure auction markets for traders to come together and to execute trades at competitively determined prices that best reflect what market participants think prices will be in the future, given today's information. Transactions can also be executed off-Exchange, i.e., in the traditional bilateral over-the-counter (OTC) arena, and submitted to NYMEX for clearing via the NYMEX ClearPort® Clearing website through procedures that will substitute or exchange a position in a regulated futures or options contract for the original OTC product.

Unlike securities markets, which serve an essential role in capital formation, organized derivatives venues such as NYMEX provide an important economic benefit to the public by serving two key functions: (1) competitive price discovery and (2) hedging by market participants. A CFTC glossary of standard industry terms informally defines hedging as follows:

> "[T]aking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; or a purchase or sale of futures as a temporary substitute for a cash transaction that

> will occur later. One can hedge either a long cash market position (e.g., one owns the cash commodity) or a short cash market position (e.g., one plans on buying the cash commodity in the future)."

The public benefits of commodity markets, including increased market efficiencies, price discovery and risk management, are enjoyed by the full range of entities operating in the U.S. economy, whether or not they trade directly in the futures markets. Everyone in our economy is a public beneficiary of vibrant, efficient commodity markets, from the U.S. Treasury, which saves substantially on its debt financing costs, to every food processor or farmer, every consumer and company that uses energy products for their daily transportation, heating and manufacturing needs, and anyone who relies on publicly available futures prices as an accurate benchmark.

As a result of the Commodity Futures Modernization Act of 2000 (CFMA), which is discussed in further detail below and which substantially modified the Commodity Exchange Act (CEA), NYMEX as a DCM generally must comply with a number of broad, performance-based Core Principles applicable to DCMs that are fully subject to the CFTC's regulation and oversight. These include eight Core Principles that constitute initial designation criteria, as well as 18 other ongoing Core Principles for DCMs. In addition to the terms of the Core Principles, the CFTC has published application guidance on compliance with the Core Principles. The guidance for each Core Principle is illustrative of the types of matters a board of trade may address, as applicable, and is not intended to be used as a mandatory checklist.

The CFMA explicitly provides that the board of trade, i.e, DCM, "shall have reasonable discretion in establishing the manner in which it complies with the core principles." The Exchange's ability to respond to rapidly changing markets as needed by introducing market-oriented changes to contracts and new risk management contracts has broadly benefited market participants.

In general, under the CEA, as a DCM, NYMEX has an affirmative statutory obligation to act as an SRO. In this connection, it is worth noting that the history of self-regulation by futures exchanges long predates the implementation of federal regulation of such markets. Indeed, self-regulatory duties were voluntarily assumed by futures exchanges not long after their inception and have been maintained over the years as a hallmark of U.S. commodity markets.

As an SRO, NYMEX must police its own markets and maintain a program that establishes and enforces rules related to detecting and deterring abusive practices. Of particular note is the series of Core Principles that pertain to markets and to market surveillance. Thus, a DCM can list for trading only those contracts that are not readily susceptible to manipulation. In addition, a DCM must monitor trading to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process. Furthermore, to reduce the potential threat of market manipulation or congestion, the DCM must adopt position limits or position accountability for a listed contract, where necessary or appropriate.

NYMEX has numerous surveillance tools that are used routinely to ensure fair and orderly trading on our markets. The principal tool that is used by DCMs to monitor trading for purposes of market integrity is the large trader reporting system. For energy contracts, the reportable position levels are distinct for each contract listed by the Exchange for trading. The levels are set by NYMEX and are specified by rule amendments that are submitted to the CFTC, following consultation and coordination with the CFTC staff.

For example, for the physically delivered NYMEX natural gas futures contract (which is referenced by NYMEX by the commodity code NG), the reportable position level is 200 contracts. The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing, among other things, on whether the futures markets price is converging with the spot physical market price as the NYMEX contract nears expiration. Large trader data is reviewed daily to monitor customer positions in the market. Specifically, on a daily basis, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. These data are used to identify position concentrations requiring further review and focus by Exchange staff. These data are collected by the CFTC and are also published in aggregate form for public view on the CFTC website in a weekly report referenced as the "Commitments of Traders" (COT) report. Historically at NYMEX, the open interest data included in large trader reports reflects approximately 80% of total open interest in the applicable contracts.

Any questionable market activity results in an inquiry or formal investigation. NYMEX closely monitors its contracts at all times in order to enforce orderly trading and liquidations. NYMEX staff additionally increases its market surveillance reviews during periods of heightened price volatility.

By rule, NYMEX also maintains and enforces limits on the size of positions that any one market participant may hold in a listed contract. These limits are set at a level that greatly restricts the opportunity to engage in possible manipulative activity on NYMEX. Futures markets traditionally list futures and options contracts as a series of calendar contract months. For an expiring contract month in which trading is terminating, NYMEX uses a hard expiration position limit (i.e., NG at 1,000 contracts). For back months of the NG futures contract, NYMEX currently maintains an any–one-month accountability level of 7,000 contracts and an all-months-combined position accountability level of 12,000 contracts. When position accountability levels are exceeded, Exchange staff conducts heightened review and possible inquiry into the nature of the position which ultimately may result in NYMEX staff directing the market participant to reduce its positions. Breaching the position limit can result in disciplinary action being taken by the Exchange. Finally, NYMEX also maintains a program that allows for certain market participants to apply for targeted exemptions from the expiration position limits in place on expiring contracts. Such hedge exemptions are granted on a case-by-case basis following adequate demonstration of bona fide hedging activity involving the underlying physical cash commodity or involving related swap agreements.

Beyond the formal regulatory requirements, NYMEX staff works cooperatively and constructively with CFTC staff to assist them in carrying out their market surveillance responsibilities. NYMEX staff and CFTC staff regularly engage in the informal sharing of information about market developments. In addition to the Exchange's self-regulatory program, the CFTC conducts ongoing surveillance of NYMEX markets, including monitoring positions of large traders, deliverable supplies and contract expirations. The CFTC also conducts routine "rule enforcement" reviews of our self-regulatory programs. NYMEX consistently has been deemed by the CFTC to have maintained adequate regulatory programs and oversight, in compliance with its self-regulatory obligations under the CEA, which is the applicable standard of review for such assessments.

Moreover, NYMEX staff officials make referrals to CFTC staff for possible investigation, such as with respect to activity by a market participant that is not a NYMEX member or member firm. Thus, for example, in an investigation of a non-member market participant, the Exchange would lack direct disciplinary jurisdiction and the consequent ability to issue effective sanctions (other than denial of future access to the trading of our products). In that situation, NYMEX staff could (and has in the past) turned over the work files and related information to CFTC staff. All such referrals are made on a strictly confidential basis. On occasion, CFTC staff has made confidential referrals to NYMEX staff as well.

Overall, there is a strong overlap between the CFTC's regulatory mission and NYMEX's role as an SRO in ensuring the integrity of trading in NYMEX's contracts. As noted previously, NYMEX itself has a strong historic and ongoing commitment to its SRO responsibilities. The NYMEX regulatory program has a current annual budget of approximately $6.2 million, which reflects a significant commitment to both staff and technology.

Statutory Changes in 2000

The CFMA streamlined and modernized the regulatory structure of the derivatives industry and provided legal certainty for OTC swap transactions by creating new exclusions and exemptions from substantive CFTC regulation for bilateral transactions between institutions and/or high net-worth participants in financial and exempt commodity derivatives, such as energy and metals.

The CFMA also permitted bilateral trading of energy on electronic trading platforms. Under CFTC rules, these electronic trading platforms are called "exempt commercial markets" with transactions on such venues only subject to the CFTC's antifraud and anti-manipulation authority. Unlike a DCM, an ECM is, in essence, completely unregulated by the CFTC. Thus, the current form of an ECM has no express statutory self-regulatory obligations to monitor its own markets. However, unlike the regulated futures exchanges, which voluntarily assumed self-regulatory obligations long before such responsibilities were codified in federal law, ECMs have generally declined to assume such duties on a voluntary basis. Thus, it is left up to Congress to mandate such duties through legislative action.

Beyond the absence of any general or overarching SRO duties, ECMs are currently not required to maintain, nor have they voluntarily implemented any manner of surveillance tools to monitor activity on their markets to ensure the integrity of products listed on their trading venues. Therefore, ECMs do not presently utilize any tools to identify market participants who maintain large positions in their listed products, nor do they use any manner of restrictions or checks on the size of open positions that may be maintained in their products.

The CFMA was broadly embraced by the derivatives industry at the time of its passage as a landmark piece of legislation, and overall it continues to be quite effective in allowing the CFTC to keep pace with very complex and dynamic financial markets. However, with an ever-evolving market place, today's markets differ dramatically from only seven years ago, causing the need for reevaluation of certain aspects of the CFMA. Due to the changes in the market place, non-regulation of certain ECMs can no longer be justified. Specifically, a series of profound changes have occurred in the natural gas market since the passage of the CFMA, including technological advances in trading, such that the regulated DCM, NYMEX, and the Intercontinental Exchange (ICE), an unregulated ECM, have become highly linked trading venues. As a result of this phenomenon, which could not have been reasonably foreseen a few short years ago, the current statutory structure no longer works for certain markets now operating as "ECMs." The regulatory disparity between NYMEX and certain ECMs has created serious challenges for the CFTC as well as for NYMEX in its capacity as an SRO. In particular, the development of arbitrage activity between NYMEX and ICE has essentially caused the venues to become linked and to serve the same economic functions.

When the CFTC was in the midst of proposing and finalizing the implementation of regulations and interpretations for the CFMA, the natural gas market continued to be largely focused upon open outcry trading executed on the regulated NYMEX trading venue. At that time, NYMEX offered electronic trading on an "after-hours" basis, which contributed only approximately 7-10% of overall trading volume at the Exchange, at best a modest proportion of the overall market. Moreover, it was more than six months following the Enron meltdown before the industry began to offer clearing services for OTC natural gas transactions.

But in determining to compete with NYMEX, ICE not only copied all of the relevant product terms of NYMEX's core or flagship natural gas futures contract, but also misappropriated the NYMEX settlement price for daily and final settlement of its own contracts. As things stand today, natural gas market participants have the assurance that they can receive the benefits of obtaining NYMEX's settlement price, which is now the established industry pricing benchmark, by engaging in trading either on NYMEX or ICE.

For some time, ICE was the only trading platform that offered active electronic trading during daytime trading hours, following the launch of their market. In September of 2006, NYMEX began providing "side-by-side" trading of its products -- listing products for trading simultaneously on the trading floor and on the electronic screen. Since that time, there has been active daytime electronic trading of natural gas on both NYMEX and ICE. The share of electronic trading at NYMEX as a percentage of overall transaction volume has increased dramatically to the extent that electronic trading now accounts for 80-85% of overall trading volume at the Exchange. The existence of daytime electronic trading on both NYMEX and ICE has fueled the growth of arbitrage trading between the two markets.

Thus, a number of market participants that specialize in arbitrage activity have established computer programs for electronic trading that automatically transmit orders to one market when there is an apparent price imbalance with the other venue or where one venue is perceived to offer a better price than the other. As a result, there is now a relatively consistent and tight spread in the prices of the competing natural gas products. Hence, the two competing trading venues are now tightly linked and highly interactive as two components of a broader derivatives market. No one could have predicted in 2000, when the exemption was crafted for energy swaps, how this market would have evolved.

In addition to the misappropriation of NYMEX's settlement price, ICE now has a significant market share of natural gas trading, and a number of observers have indicated that most of this trading in the ICE Henry Hub swap is subsequently cleared by the London Clearing House, the organization contracted by ICE to provide clearing services. Thus, there is now a concentration of market activity and positions occurring on the ICE market as well as the exchange-like concentration and mutualization of financial risk at the clearing house level from that activity.

Impact on Regulated Exchange from Lack of Regulation of Other Exchanges

From its vantage point as a DCM, NYMEX was able to observe first-hand how this regulatory disparity operated in the failure of Amaranth, a seven billion dollar hedge fund that focused upon trading of energy products and that was active in the NG contract. In August of 2006, NYMEX proactively took steps to maintain the integrity of its markets by ordering Amaranth to reduce its open positions in the natural gas futures contract. In June of this year, the U.S. Senate's Permanent Subcommittee on Investigations (PSI) issued a report on "Excessive Speculation in the Natural Gas Market." (PSI Report). As detailed in the PSI Report, Amaranth reduced its NYMEX position but sharply increased its positions on the unregulated and nontransparent ICE electronic trading platform. Because ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive with each other, Amaranth's response to NYMEX's regulatory directive admittedly reduced its positions on NYMEX but did not reduce Amaranth's overall market risk or the risk of Amaranth's guaranteeing clearing member. Furthermore, the integrity of NYMEX markets continued to be affected by and exposed to Amaranth's outsize positions in the natural gas market. Unfortunately, neither NYMEX nor the CFTC had an efficient means to monitor Amaranth's positions on ICE or to take steps to have Amaranth reduce its participation in that trading venue.

Because ICE price data is available only to its market participants, NYMEX does not have the means to conclusively establish the extent to which trading of ICE natural gas swaps contributes to, influences or affects the price of the related natural gas contracts on NYMEX. However, what is clear is that as a consequence of the extensive arbitrage activity between the two platforms and ICE's use of NYMEX's settlement price, the two natural gas trading venues are now tightly linked and highly interactive. NYMEX staff has been advised that during most of the trading cycle of a listed futures contract month, there is a range of approximately only five to twelve ticks separating the competing NYMEX and ICE products (the NYMEX NG contract has a minimum price fluctuation or trading tick of $.001, or .01 cents per mmBtu). These two trading venues serve the same economic functions and are now functionally equivalent.

NYMEX staff has also been advised by market participants who trade on both markets that a rise or fall in price on one trading venue will be followed almost immediately by a rise or fall in price on the other trading venue, whether the change in price is initiated on either NYMEX or ICE. These observations of real-world market activity support the conclusion that trading of ICE natural gas swaps do in fact contribute to, influence and affect the price of the related natural gas contracts on NYMEX. These observations are now also supported by the research conclusions contained in an October 24, 2007 CFTC report to Congress that is noted below.

Aside from a lawsuit brought by NYMEX against ICE for the use of NYMEX's settlement prices, NYMEX does not have any other ongoing formal relationship with ICE. In particular, as ICE and NYMEX are in competition with each other, there are currently no arrangements in place - such as information-sharing - to address market integrity issues. As previously stated, NYMEX as a DCM does have affirmative self-regulatory obligations; as an ECM, ICE has no such duties. Yet, from a markets' perspective, the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive where trading activity and price movement on one venue can quickly affect and influence price movement on the other venue.

In connection with the Exchange's ongoing routine market surveillance programs and in conjunction with procedures that were described previously, NYMEX staff was aware of and monitored all open positions that Amaranth maintained in NYMEX trading venues, including the physically delivered natural gas futures contract. NYMEX conducted regular reviews of Amaranth's open positions in excess of position accountability levels prescribed in NYMEX Rule 9.26. The Exchange notes that various other contracts it offers, such as American and European options on natural gas, along with other various futures contracts, are aggregated into the Natural Gas Futures Contract (NG) for monitoring accountability levels on a futures equivalent basis. During the period in question documented by the Report, the NYMEX financially-settled Henry Hub Natural Gas futures contract (NN), was also aggregated into the Natural Gas Futures Contract for monitoring accountability levels on a "futures equivalent" basis, i.e., across several related NYMEX contracts.

As such, Amaranth's positions on NYMEX, when taken on a futures equivalent basis, were of significantly less magnitude on a percentile basis than is the case when reviewing the NG contract in isolation on a "futures-only" basis. NYMEX staff did routine monitoring of back month positions, based upon the application of position accountability levels applied on a futures equivalent protocol, which is the current standard procedure for U.S. futures exchanges. We note that consistent with statements made by NYMEX Chief Executive and President, James Newsome, NYMEX later amended certain position accountability rules in connection with lessons learned from the Amaranth matter In addition to conducting market surveillance on Amaranth's activities, NYMEX staff also conducted daily risk-based analytical "stress" tests of Amaranth's position at its carrying clearing member.

NYMEX staff members directed Amaranth in early August 2006 to reduce its open positions in the first two nearby contract months based upon what they believed to be a significant concentration in NYMEX markets in natural gas (relying upon an NG "futures only" approach). NYMEX believes that such a directive was prudent and effective with respect to reducing positions carried on our platform. As previously noted, NYMEX maintains no information sharing agreement of any kind with ICE; the Exchange also observes that, during the period in question, the CFTC was not receiving any regular information from ICE as to positions on its platform either. As a consequence, a shift of positions by Amaranth from NYMEX to ICE was undetectable both by NYMEX and the CFTC.

It is important to distinguish the activity of Amaranth from the category of hedge funds as a class of market participant. NYMEX issued a study in March of 2005, comprised of an internal market data study of trading volume and open interest analyzing the participation of hedge funds (broadly defined) in two of the Exchange's largest futures markets during 2004. The study analyzed the influence of hedge fund participation on price volatility and included a statistical test for causality. The findings were that hedge fund participation as a class of market participant did not cause volatility and, in fact, appeared to *dampen* volatility. In the natural gas futures contract, hedge funds made up 9.05% of trading volume. As a percentage of open interest, hedge funds constituted 20.4% in the natural gas futures market. In general, the study found that hedge funds tended to hold positions significantly longer than other market participants, indicating that they could be a non-disruptive source of liquidity to the market. An update conducted by Exchange staff from January to September 2006 found that while the percentage of volume contributed by hedge funds had increased (to 20.86%), the overall findings of the original study remained the same.

NYMEX is not supplied position data regarding other venues on a regular basis by either a market participant or another trading venue (such as ICE or other OTC platforms). However, by rule, NYMEX has broad authority to request and to be supplied "information" with respect to a position in excess of the prescribed accountability levels. NYMEX did gather information regarding expiring contracts in the process of approving hedge exemptions subject to NYMEX Rule 9.26 for Amaranth where they represented offsetting exposure.

Need for Legislative Change

We do not believe that the case has been made and therefore do not support any new regulation of derivatives transactions that are individually negotiated and executed off-exchange, i.e., not on a trading facility between eligible participants in the traditional bilateral OTC market. On the other hand, we *do* believe that ECMs like ICE that function more like a traditional exchange and are linked to an established exchange, should be subject to CFTC regulation. In addition, the continuing exchange-like aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple effects for other clearing members and for various clearing organizations that share common clearing members.

Consequently, legislative change is now necessary to address public interest concerns created by the current structure. There is the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

CFTC Report

By letter dated October 24, 2007, the CFTC delivered to Congress a report that included recommendations to increase the oversight of some trading activity on electronic trading facilities. According to the CFTC, their report was designed to provide recommendations "to strike a balance between the appropriate level of market oversight and transparency while promoting market innovation and competition to ensure that these markets remain on U.S. soil," The CFTC report was developed in consultation with the President's Working Group on Financial Markets. The Commission's legislative recommendations include establishing the following for certain ECM contracts that serve a significant price discovery function:

1. **Large Trader Position Reporting** – comparable to reporting requirements that currently apply to contracts traded on regulated exchanges;

2. **Position Limits and/or Accountability Level Regime** – comparable to those that currently apply to similar contracts traded on regulated exchanges;

3. **Self-Regulatory Oversight** – designed to detect and prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process; and

4. **Emergency Authority** – to prevent manipulation and disruptions of the delivery or cash-settlement process.

Beyond the legislative changes proposed, the Commission also announced its intention "to: (1) establish an Energy Markets Advisory Committee to conduct public meetings on issues affecting energy producers, distributors, market users and consumers; and (2) work closely with the FERC to educate and develop best practices for utilities and others who use NYMEX settlement prices as hedging vehicles and benchmarks in pricing their energy products."

NYMEX strongly supports the CFTC's proposals. In this regard, the Exchange has consistently maintained that regulatory reform is necessary in order to promote transparent, fair and orderly markets, and the Commission's report validates this approach. ECMs contracts that serve a significant price discovery function trigger a number of public policy concerns and warrant a higher degree of CFTC oversight and regulation.

NYMEX agrees with the CFTC's conclusion and legislative recommendations that these contracts should be subject to large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself. These mechanisms have enabled NYMEX to provide market integrity and stability to the energy markets. NYMEX also looks forward to continuing to work with the CFTC and with the industry to establish best practices for the energy markets.

Following transmission of the CFTC's report to Congress, Senator Mike Crapo, by letter dated October 30, 2007, requested the views of the President's Working Group on Financial Markets (PWG) on the CFTC report and its recommendations. Last month, the PWG responded to Senator Crapo and expressed its support for the CFTC's recommended legislative changes. The PWG also noted its belief that the CFTC proposal "strikes the appropriate balance between protecting consumers and markets from trading abuse while ensuring continuing growth and innovation in the U.S. markets."

CFTC-FERC Jurisdictional Issues

Section 2(a)(1) of the Commodity Exchange Act provides that "[t]he Commission shall have *exclusive jurisdiction* … *with respect* to accounts, agreements … , and *transactions involving contracts of sale of a commodity for futures delivery, traded or executed on a [designated contract market* or derivatives transaction execution facility] …" (emphasis added). This statutory grant of exclusive jurisdiction to the CFTC is unequivocal on its face. It embodies the clear intent of Congress to vest sole authority in one expert agency. NYMEX believes that this well-reasoned and wise decision of

Congress must be upheld. To allow FERC or any other federal agency to interpret its authority so broadly that it nullifies the plain meaning of the language would conflict with the clear Congressional intent. The resulting untended consequences would do grave harm to the markets, consumers and U.S. economy.

The Energy Policy Act of 2005 granted FERC new manipulation authority. At the same time, the EPAct directed that FERC establish a memorandum of understanding with the CFTC to work together in cooperation and to share information. In that memorandum of understanding, the FERC specifically conceded and acknowledged that the CFTC: "has **exclusive** jurisdiction with respect to accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery. . . ." (emphasis added.) More recently, however, FERC has broadly interpreted that authority to reach NYMEX futures transactions because many of FERC's jurisdictional entities use the NYMEX settlement price as a benchmark for their spot market pricing. The CFTC and FERC are now both exercising authority over the same conduct under different standards. The legal and practical arguments against this outcome are addressed below.

Statutory interpretation and legislative history arguments provide the legal support for preserving the CFTC's exclusive jurisdiction. These arguments are made clearly and persuasively in the recent futures industry amicus brief in support of CFTC exclusive jurisdiction and Defendant Amaranth Advisors' stay motion filed in the U.S. District Court for the Southern District of New York. NYMEX believes that a brief overview of some of those arguments is necessary and appropriate in the context of this hearing.

First, exclusive jurisdiction was intended to make the CEA and CFTC regulations the supreme body of law for futures markets and trading thereon. Congress enacted CEA exclusive jurisdiction to avoid legal uncertainty and the related market confusion and economic cost. The operation and competitiveness of U.S. futures markets are best served by virtue of one body of law applied exclusively to futures markets and trading. It ensures a cohesive and well-reasoned regime that provides financial and market integrity and ensures the legal certainty needed for the continued growth and competitiveness of U.S. futures markets. The FERC itself once found that Congress intended the CEA's exclusive jurisdiction provision "to give a single expert agency [the CFTC] the responsibility for developing a coherent regulatory program for the commodities industry and to prevent the costs and confusion associated with multiple regulators." New York Mercantile Exchange, No. EL 95-81-000, 74 FERC ¶ 61311 (1996).

Second, "jurisdiction … with respect to … transactions involving" NYMEX natural gas futures contracts – surely includes jurisdiction over an order to buy or sell, as well as the buying and selling of a futures contract. In fact, all trading conduct and misconduct, such as futures price manipulation, is covered by the terms "with respect to" and "involving" orders to buy and sell futures contracts and is therefore under the CFTC's exclusive jurisdiction. Any other interpretation would contradict the plain meaning of the statute and the clear intent of Congress.

Third, Congress did not create an exception to CFTC exclusive jurisdiction in 2005. Historically, when Congress has limited the CFTC's exclusive jurisdiction relative to particular products, it has done so explicitly through amendments to Section 2(a)(1)(A). To date, the limitations on the CFTC's exclusive jurisdiction apply to securities related products subject to the SEC's authority and not to energy products. If Congress intended to carve out a portion of the CFTC's jurisdiction to give to FERC, it is reasonable to expect that it would have expressly done so, as in the past. Furthermore, to provide an exception to the CFTC's exclusive jurisdiction in the context of the Energy Policy Act of 2005 would have undermined the purpose of the grant of exclusive jurisdiction in the Commodity Exchange Act. This outcome would be wholly inconsistent with the rules of statutory interpretation.

Finally, the legislative history unequivocally affirms the scope of the CFTC's exclusive jurisdiction. Congress enacted exclusive jurisdiction in the Commodity Futures Trading Commission Act of 1974. The Conference Committee, in reconciling the differing House and Senate versions of the pending bill's exclusive jurisdiction provisions, decided the House version was too ambiguous, and adopted the Senate's provision to ensure that "the Commission's jurisdiction over futures contract markets …is exclusive … and the Commission's jurisdiction, where applicable, supersedes State as well as Federal agencies." (WB: Cites Conf Rep at 35; S. Rep. at 6). The Conference Committee further explained that "under the exclusive grant of jurisdiction to the Commission, the authority of the Commodity Exchange Act (and regulations issued by the Commission) would preempt the field insofar as futures regulation is concerned." Conf Rep at 35.

Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation – a function which requires highly specialized skills. As intended, the CFTC has developed into an expert in futures market oversight and effectively carries out its statutory mandate "to deter and prevent price manipulation or any other disruptions to market integrity." (Section 3 of the CEA). This well-reasoned and successful approach to regulation of futures markets is now threatened by dueling regulators. The CFTC and FERC have different statutory mandates. The authority that FERC claims under its new manipulation mandate cannot co-exist with the CFTC's exercise of its exclusive jurisdiction over futures markets and transactions.

This reality was made clear in the recent enforcement actions brought under different standards for manipulation by both regulators against Amaranth Advisors for trading activity occurring on NYMEX. The statutory authorities under which FERC and CFTC operate with respect to preventing manipulation of the spot and futures markets differ significantly. FERC derives its authority from section 315 of the Energy Policy Act of 2005, which gives them manipulation authority over “any entity” that commits manipulation, directly or indirectly, in connection with FERC-jurisdictional transactions. FERC broadly interprets this new authority to include the ability to bring enforcement action on futures exchange activity, which is under the CFTC’s exclusive jurisdiction. In developing the rule, FERC drew heavily from the Securities and Exchange Commission’s rule 10b-5, under which the Supreme Court has defined manipulation as conduct “designed to deceive or defraud investors by *controlling or artificially affecting* the price of securities” or practices that “artificially affect market activity.”

On the other hand, the CFTC’s anti-manipulation authority is derived from Section 9(a) of the Commodity Exchange Act. It provides that it is a felony to “. . . manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered . . . false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce . . . .”

Having two different standards for manipulation targeting the same trading activity and being enforced by two different federal agencies is a recipe for disaster. It causes confusion and uncertainty in the markets, is costly to our business and will impact the competitiveness of U.S. futures markets at home and abroad.

Example of FERC's Interest in Day-to-Day Regulation of Futures Exchanges

NYMEX has also experienced the impact of overlapping jurisdiction on the regulatory front. At the insistence of FERC, NYMEX changed its procedures for monitoring positions in excess of the expiration position limits in its expiring natural gas contract. That procedural change *resulted in a 40% loss of volume* in natural gas contracts on NYMEX in the expiration month. NYMEX recently became aware that data has been compiled, which confirms our suspicions that the volume leaving NYMEX has moved to the non-transparent, price linked, unregulated electronic market for natural gas. This is a prime example of regulatory arbitrage: market activity on the highly regulated futures exchange shifting to the unregulated market to avoid rules designed specifically to deter and prevent market manipulation.

On February 16, 2007, in an effort to cooperate with FERC and following consultation with CFTC staff, NYMEX issued a compliance advisory in the form of a policy statement related to exemptions from position limits in NG futures contracts NYMEX adopted this new policy on an interim basis in a good faith effort to be cooperative with federal regulators. However, as detailed below, this experience has had an adverse impact on NYMEX's trading venues and is creating the result of shifting trading volume (during the critically important NG closing range period at NYMEX on the final day of trading) from our regulated trading venue to unregulated trading venues.

Pursuant to that advisory, NYMEX instituted new uniform verification procedures to document market participants' exposure justifying the use of an approved hedge exemption in the NG contract. These procedures apply to all market participants who carry positions above the standard expiration position limit of 1,000 contracts going into the final day of trading for the expiring contract. Specifically, prior to the market open of the last trading day of each expiration, NYMEX now requires all market participants with positions above the expiration position limit of 1,000 contracts to supply information on their complete trading “book” of all natural gas positions linked to the settlement price of the expiring NG contract. Positions in excess of 1,000 contracts must offset a demonstrated risk in the trading book, and the net exposure of the entire book must be no more than 1,000 contracts on the side of the market that could benefit by trading by that market participant during the closing range.

NYMEX has now experienced ten expirations of a terminating contract month in the NG futures contract since this new compliance advisory went into effect. NYMEX staff has observed a number of instances where market participants have reduced their positions before the open of the final day of trading rather than share sensitive trading information about proprietary trading with Exchange staff. As a result, NYMEX has observed reduced trading volume on the final day of trading in an expiring contract month relative to the final day of trading for the same calendar contract month in the prior year. The average volume on the final day of trading for these ten expirations were 30,955 versus 38,623 for the corresponding contract month in the prior year, or an 19.85% reduction

Even more significantly, the closing range volume for the 30-minute closing period on the final day of trading is sharply lower than for volume during the final day closing range for the same calendar contract month in the prior year. In most instances, the volume in the closing range is less than half of the volume in the closing range for the same calendar contract month in the prior year. The average closing range volume on the final day of trading for the ten expirations was 13,136 versus 22,319 for the corresponding contract month in the prior year, or a 41% reduction.

Overall market volatility in the natural gas market is somewhat lower this spring and summer than from comparable periods a year ago. This lower volatility stems from a lack of price volatility in the underlying physical cash commodity and in our opinion not from our implementation of this advisory. NYMEX's analysis of the volatility during on expiration day over the last five years suggests that other factors could have contributed equally to the decrease in volatility. The five-year analysis shows that the reduced volatility is consistent across the board during the timeframe in question. Thus, the volatility level under the new closing range procedure implemented in early 2007 is not inconsistent with typical trading patterns for NG. It is also worth noting that one of the biggest players in the natural gas market (Amaranth) no longer is present, yet another factor, which could be affecting volatility. Lastly, we have not experienced the harsh winter weather since implementation of the new procedure, which could also account for less volatility.

That stated, the lower volumes seen during the recent 30-minute closing ranges on the final day of trading since the implementation of the new policy actually create the potential for even greater volatility in the event of any significant market move. Thus, the new interim policy implemented by NYMEX on a good-faith basis has not only led to reduced volume on NYMEX during the critical 30-minute closing range period, which presumably has shifted to the unregulated trading venues, but has also failed to solve the structural imbalances brought to light by Amaranth's trading. In addition, this policy could create new problems by diminishing the vitality of the natural gas industry's pricing benchmark. Consequently, NYMEX believes that legislative change is now necessary and appropriate.

NYMEX believes that the CFTC's role continues to be over futures trading and markets and that the FERC's new found authority should cover policing natural gas and electricity cash market manipulation. The CFTC and FERC can carry out their statutory duties in the futures and spot markets, respectively. NYMEX believes that it is better public policy for CFTC and FERC to cooperate and coordinate in instances where both spot and futures markets are involved in a situation involving a bad actor, rather than having FERC exercising direct authority over transactions that are under the exclusive jurisdiction of the Commodity Exchange Act.

At present, though, NYMEX is caught in an untenable situation. The FERC's indirect regulatory actions regarding NYMEX have had a direct impact on the volume and liquidity in the benchmark natural gas futures contract. This is a clear example of unintended consequences, which threatens the all important price discovery function of our market. The difficulties associated with conflicting regulatory standards also will severely undermine the ability of NYMEX and other regulated exchanges to carry out their SRO responsibilities.

Foreign Boards of Trade

While much of the focus on Capitol Hill has been on domestically based ECMs, similar issues potentially could arise with regard to U.S.-based products that are listed for trading on foreign boards of trade. As a note, NYMEX has long been a champion of vigorous competition and of greater globalization of services and products. As a rapidly growing global market presence, we have offices in London and Tokyo as well as in Singapore.

We also note that there have been substantial advances in technology since the former era of closed end proprietary trading systems. New exchanges have emerged that operate on a solely electronic basis, and products have now been listed under the CFTC staff no-action process that are parallel (if not identical) to other products listed by existing U.S. exchanges that are subject to full CFTC regulation. NYMEX believes that it would be prudent from time to time for the Commission or Commission staff to conduct a thorough review f of foreign markets operating in the U.S. under existing staff no-action letters.

In our recent experience, "regulatory arbitrage" is not a hypothetical concern but is actually already underway for certain of our listed products. This process could actually harm markets because of the distortion of market efficiency occurring when customers make choices among the same or similar products on the basis of differences in regulatory treatment among providers rather than on the basis of intrinsic distinctions in the products themselves or in related services. There are certain products now listed on foreign boards of trade that appear to be economically linked to competing products listed on a DCM. Thus, we believe that this issue warrants further examination both by Congress and by the CFTC.

Finally, we believe that the CFTC should be vigilant and proactive in ensuring that U.S. exchanges are not competitively disadvantaged by foreign exchanges operating under less stringent rules than those imposed on U.S. markets and to incorporate regulatory parity and consistency principles as fundamental components of the review process of applications being submitted to CFTC division staff by overseas exchanges.

Transaction Tax

A few proposals have surfaced recently for transaction tax on derivatives transactions. The PSI Report contained several recommendations, including a recommendation that "Congress should increase the CFTC budget and authorize CFTC user fees to help pay for the additional cost."

The PSI Report stated that the CFTC's budget should be increased "to provide the staff and technology needed to monitor, integrate, and analyze real-time transactional data from all U.S. commodity exchanges, including NYMEX and ICE." NYMEX agrees with this assessment and supports an expanded budget for the CFTC so that it may properly carry out its regulatory mission. However, NYMEX believes strongly that such funding is best addressed through the general revenue process, rather than through a special tax.

More recently, by letter dated September 4, 2007, the Office of Management and Budget (OMB) submitted proposed legislation to House Speaker Nancy Pelosi. Under that proposal, each derivatives clearing organization would need to pay to the CFTC a fee for any transaction cleared at a rate to be determined by the CFTC. As NYMEX understands it, under either proposed version noted above of this user fee or transaction tax, the tax would not be imposed on foreign boards of trade that listed competing products and that are currently offering direct electronic access to their markets to market participants based in the U.S., unless those products are cleared by a clearing organization that is subject to CFTC regulation.

In addition, the OMB proposal would create a significant disincentive to use of clearing services for OTC agreements and transactions. This result would undermine the stance taken by Congress in 2000 to encourage the use of clearing services to mitigate counter-party credit risk for OTC transactions and thus to enhance the financial integrity of transactions executed in OTC trading venues.

These proposals also run directly counter to the high-level efforts by key policymakers to strengthen the global competitiveness of U.S markets. In a November 2006 speech on the competitiveness of U.S. capital markets, Treasury Secretary Hank Paulson stated that "competitive capital markets will pave the way for continued economic growth that benefits all Americans." In addition, a study of New York's financial services industry released by Senator Chuck Schumer and New York Mayor Michael Bloomberg warned that "to maintain our success in the long run, we must address a real and growing concern: in today's ultra-competitive global marketplace, more and more nations are challenging our position as the world's financial capital." Implementing a tax on transactions conducted on U.S. commodity and derivatives markets would cause existing business to leave U.S. markets to avoid taxation. Equally as concerning, the tens of thousands of jobs that the industry provides in the U.S. may move or disappear as well.

Currently, U.S. futures exchanges such as NYMEX collectively spend tens of millions of dollars every year on internal self-regulatory programs. In addition, with regard to regulated futures transactions, the U.S. futures regulatory system already assesses our customers a fee to provide for the self-regulation performed by the National Futures Association (NFA), a self-regulatory organization authorized by Congress. By adding a new user fee at the clearing stage to the NFA assessment, which is calculated at the transactional stage, the OMB proposal n effect would be taxing participants both at the trading and at the clearing level Taxing market participants twice is both burdensome and unfair. It could encourage major market participants to avoid trading in U.S. derivative venues and instead shift trading overseas. Any such loss of market liquidity would harm hedgers and other U.S. businesses that look for the most cost-efficient venue to hedge the price risks they face every day. In addition, imposing this tax burden on U.S. market participants is particularly inappropriate given the public interests served by the U.S. futures markets, and the price discovery and dissemination benefits conferred by the exchange markets on many thousands of non-market participants.

The proposed user taxes would also greatly increase the trading costs of market-makers who provide liquidity vital to U.S. exchange markets. Their profit margins are razor thin, yet they provide critical liquidity that makes U.S. exchange markets more efficient and cost-effective to all customers who use them to manage risk. These individuals and small businesses would be forced to bear the weight of the tax, without regard to their profitability.

Finally, the Commodity Exchange Act establishes certain core purposes for the regulation of derivatives transactions. These purposes of the CEA thus include “to ensure the financial integrity of all transactions subject to this Act” and “to promote responsible innovation and fair competition among boards of trade, other markets and market participants.” The OMB’s proposed new tax would create a new and substantial disincentive to use of clearing services provided by CFTC-regulated clearing organizations. Those same OTC transactions could be shifted to a non-U.S. clearing organization for clearing. In addition, by imposing a tax only on transactions cleared by a CFTC-regulated clearing organization, Congress would be creating an unfair advantage for foreign boards of trade that already are listing products that are look-alikes of domestically traded products. Transactions cleared overseas would fall entirely outside the scope of the OMB proposal and hence the OMB immediately would create a real incentive for firms to shift their trading activity to overseas markets.

Conclusion

NYMEX is fully regulated by the CFTC, which by statute has long had exclusive jurisdiction over futures contracts, trading and markets. In addition to the CFTC’s direct monitoring of futures trading, as a DCM, NYMEX has an affirmative statutory obligation to act as a self-regulatory organization, relying upon the standards set by statute and by CFTC regulation and interpretation. Self-regulatory duties were voluntarily assumed by futures exchanges many years before the federal regulation of commodity markets. As an SRO, NYMEX routinely uses tools such as large trader reporting and position accountability and position limit levels to monitor and to police trading in our contracts.

A new statutory tier of trading facility, the exempt commercial market, was added to the CFTC’s governing statute in 2000. The ECM is essentially exempt from substantive CFTC regulation and also has no explicit SRO duties by statute. In addition, to date, ECMs have not voluntarily assumed any SRO duties. As a result of market changes that were not anticipated in 2000, such as the effective linking of trading on unregulated venues with trading on regulated venues of competing products, certain ECMs now serve in a price discovery role and thus trigger public policy concerns and warrant a higher degree of CFTC oversight and regulation.

A recent CFTC report to Congress recommends that such contracts should be subject by statute to large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself. NYMEX strongly supports the CFTC's targeted and focused legislative proposals. The CFTC's recommended changes are also supported by the President's Working Group on Financial Markets.

Finally, Congress created the CFTC in 1974 and provided the new agency with exclusive jurisdiction over futures markets. Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation, a function which requires highly specialized skills, and the CFTC has developed such expertise. In subsequent reauthorizations, when Congress intended to create limited exceptions to that authority, it has always done so through express amendments of the CFTC's governing statue. Consequently, most observers have concluded that Congress did not intend to alter the CFTC's exclusive jurisdiction with the Energy Policy Act of 2005. The contrary interpretation now being pursued by FERC substantially harms futures markets by adding the cost and uncertainty of conflicting standards. It also severely undermines the ability of NYMEX and other regulated exchanges to carry out their SRO responsibilities.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions members of the Subcommittee may have.

ONE PAGE SUMMARY OF NYMEX WRITTEN TESTIMONY

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