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Remarks

Integrity of the Futures Markets and the Role of Transparency

Remarks by Commissioner Jill E. Sommers Before the FIA Asia Derivatives Conference, Tokyo, Japan

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Good morning. I am very pleased to be here this morning to represent the Commodity Futures Trading Commission (CFTC or Commission) at this conference and would like to thank John Damgard and the Futures Industry Association for inviting me. Yesterday's Regulators' Meeting was very informative, and I always welcome the opportunity to learn about the latest developments in the industry.

The U.S. futures markets have been the focus of intense scrutiny by lawmakers, the press and the public over the past year as prices for crude oil and many agricultural products reached record highs. The question on everyone's mind is whether speculative trading is responsible, especially through the influx of new traders into the markets such as pension and endowment funds seeking exposure to commodities through passive long-term investment in commodity indexes, and swap dealers who seek to hedge price risk resulting from their over-the-counter (OTC) activity. Those participating in the debate have acknowledged that speculation is a necessary component of healthy markets. It is speculators who take on the risk that hedgers seek to shed and provide the liquidity that is the lifeblood of futures trading. There is a sense by some, though, that "excessive" speculation has pushed prices beyond levels warranted by supply and demand and that something must be done to rein it in.

One of the primary tasks of market regulators is to foster the high level of market integrity necessary to preserve the important risk management and price discovery functions the futures markets perform. So, we must ask ourselves, how do we ensure that the markets are working as they should? One answer is transparency.

Transparency is the cornerstone of a well functioning regulatory system. Regulators must have sufficient reliable information from the marketplace in order to ensure that the

exchanges under their oversight are operating in an open and competitive manner, free from manipulative influences or other price distortions. The centerpiece of the CFTC's market surveillance program is its large trader reporting system, which requires exchanges, clearing members, futures commission merchants and foreign brokers conducting business on our markets to file daily reports with the Commission showing the futures and options positions of traders holding positions above specified reporting levels. Using large trader reports, Commission surveillance economists can view the largest traders in a specific market, a single trader across several markets, and a pattern of trading over a specific time frame to determine when a position may pose a threat by exceeding position limits or accountability levels.

Making sure we have the right information to detect potential problems is not enough though. Public confidence in the markets is also crucial. Unless the public is assured that the markets are operating efficiently and free from abuse, commercial producers and users of the commodities underlying futures transactions will be reluctant to use the markets to hedge their price risks, and the information they would otherwise bring to the markets—essential to discovering appropriate prices—will be lost. One of the tools the CFTC has developed to aid it in disseminating information to the public is the Commitments of Traders (COT) reports, which are published weekly on the Commission's website. The COT reports classify traders as either commercial or noncommercial, and show the aggregate open interest for all futures and option markets in which 20 or more traders hold positions equal to or above large trader reporting levels. Persons making marketing and trading decisions, such as commercial marketing and hedging advisors, cash market merchandisers, producers and processors, as well as academic and economic researchers, use data contained in the COT reports to analyze trading activity, supply and demand, price trends, and other market factors. But I want to make a clear distinction here; although the COT reports are compiled by our surveillance economists, they are not used for market surveillance or for any regulatory purpose, including the granting of exemptions from speculative limits.

A third area where transparency is important is international information sharing between regulators. Futures markets are global and exchanges and regulators alike have been facing the challenges of cross-border trading for many years. In the face of these challenges, the CFTC has worked to develop a mutual recognition process with our counterparts around the world that strikes a balance between the need to maintain confidence in the functioning and integrity of our markets without imposing unnecessary or duplicative regulation. A close working relationship between regulators is particularly important when cross-border trading is linked through the listing of closely related or look-alike contracts.

Today, I would like to talk about steps the CFTC has taken over the last year to enhance transparency in each of these areas and to improve its ability to monitor and address emerging market trends.

The first area was a topic of concern when I came to the Commission over a year ago involving what has been referred to as "dark markets." The term "dark markets" can mean different things to different people, but has most often been used to refer to markets that are not subject to the highest level of U.S. regulation, i.e., those registered with the Commission as derivatives contract markets (DCMs). One type of market that

is subject to a lighter regulatory touch is the exempt commercial market (ECM), an exchange category sanctioned by the U.S. Congress in 2000. ECMs are electronic trading facilities on which trading is limited to transactions in exempt commodities—primarily energy and metals—by eligible commercial entities, a sophisticated group of market participants trading on their own behalf. ECMs have never been “dark markets” in the sense that they operated free from all oversight. From the outset they were subject to recordkeeping and certain reporting requirements and were required to produce any information related to their business requested by the CFTC upon special call. They were not, however, subject to large trader reporting or required to establish position limits or accountability levels as required for DCMs. Nor were they required to monitor the trading on their platforms.

Initially, most ECMs were small operations with low trading volumes compared to DCMs. One ECM in particular, however, the IntercontinentalExchange (ICE), evolved to become a major trading venue for natural gas in direct competition with the New York Mercantile Exchange’s (NYMEX) benchmark natural gas futures contract. Concerns were raised that traders could avoid position limits and accountability levels set by NYMEX by taking their business to ICE, where they could establish positions sufficiently large to improperly influence prices.

In September 2007, the Commission held a hearing to examine the relationship between trading on DCMs and ECMs and whether the CFTC’s surveillance capabilities were sufficient given this new interconnection. Based upon its review, the Commission found that natural gas traders viewed ICE and NYMEX as a single market and looked to both exchanges when determining where to execute a trade at the best and most liquid price. The Commission concluded that this connection between the markets warranted increased regulatory oversight over trading on ECMs when an ECM contract matures and begins to serve a significant price discovery function. It therefore recommended that Congress amend the Commodity Exchange Act to require large trader reporting for ECM contracts that serve a significant price discovery function, to require ECMs to adopt appropriate position limits or accountability levels for such contracts and to monitor trading to detect and prevent manipulation, and to give both ECMs and the CFTC emergency authority to address adverse market events related to the trading of such contracts. I am happy to say that Congress passed legislation earlier this year adopting the Commission’s recommendations, making this type of trading fully transparent and subject to appropriate regulatory oversight.

The second issue involves ICE Futures Europe. The Commission, working with Great Britain’s Financial Services Authority (FSA), took steps to improve transparency and adopt consistent regulatory controls over another set of linked contracts, NYMEX’s benchmark crude oil contract and a look-alike contract traded on ICE Futures Europe. After consultation with the FSA, the CFTC conditioned ICE Futures Europe’s direct access to U.S. customers on, among other things, the implementation of comparable position limits or accountability levels and providing the CFTC with daily large trader reporting in a form that can be fully integrated with its market surveillance systems and COT reports. The Commission intends to apply these new direct access conditions to any future requests by foreign exchanges for direct access to U.S. customers where the exchange in question lists a contract linked to a contract listed on any U.S. exchange.

Finally, significant concerns have been raised about whether money flowing into the futures markets from index fund trading may be artificially inflating commodity prices and whether speculative activity exceeding position limits conducted through swap dealers in the OTC market is making its way onto the futures markets through hedge exemptions granted to swap dealers for their on-exchange trading. To better understand the activity of index traders and swap dealers and their potential to influence the futures markets, in May the Commission announced it would conduct a special call regarding the activity of index traders and swap dealers engaged in OTC commodity index and other derivatives business, and would review whether classification of the on-exchange activity of these traders can be improved for regulatory and reporting purposes. The survey entailed the collection, organization and analysis of trading involving hundreds of counter-parties, millions of transactions, and billions of dollars over a six-month period. Needless to say, the information received was extremely complex and presented staff with the formidable challenge of extracting meaningful market information from such a substantial and non-standardized OTC data set. Given the unprecedented nature of the exercise there may be a margin of error in the precision of the numbers. The special call is on-going, however, and precision of the data will likely improve as staff continues to work with the relevant firms and further review and refine the figures.

- The scope of the survey attempted to answer the following questions:
- How much commodity index trading is occurring in the OTC and on-exchange markets combined?
- How much commodity index trading is occurring by specific commodity in both the OTC and on-exchange markets?
- What types of clients use swap dealers for OTC trading? and
- Had these OTC swap positions been brought directly to an exchange, would they have exceeded position limits or accountability levels?

A staff report on the survey was released last week and is available on the Commission's website. I will not go into all the details here, but urge you to read it if you have not done so already.

The survey did not attempt to accurately quantify the amount of speculation versus hedging occurring in the futures markets, which can be a difficult distinction to make in practice. Traditionally, those exposed to price risk arising from activities in the physical market for a commodity have been viewed as hedgers, while those without such exposure, such as market makers, have been called speculators. In practice, however, traditional physical market hedgers may also speculate on price movements, while entities engaged in significant speculative activity may also have commercial lines of business in the underlying cash markets. Nevertheless, for purposes of analyzing the types of individual, bilateral trades made through swap dealers, the Commission required the survey respondents to identify the principles behind the trades, where that could be determined, and characterize them as either commercial or noncommercial, the former being those engaged in physical market activities and the latter those who were not.

Based on the responses, Commission staff was able to determine the number of swap dealer clients with aggregate on-exchange and off-exchange positions that exceeded

exchange position limits or accountability levels on June 30, 2008. Out of the 550 clients identified, 18 noncommercial traders had aggregate positions that would have been above a limit or accountability level had they been brought directly to an exchange. Although the amounts by which each of these traders exceeded a limit or level were generally small, there were a few instances in which the amounts were significantly higher.

Another main focus of the survey was to determine the total amount of OTC and on-exchange commodity index trading occurring in the markets as prices rose during the first six months of 2008. For the NYMEX crude oil contract, the total notional value of index trading rose from $39 billion to $51 billion, while the aggregate long positions of commodity index participants declined by 11 percent, from approximately 408,000 contracts to 363,000 contracts. The rise in notional value appears to have resulted from an increase in the price of oil, from about $96 per barrel to $140 per barrel, rather than an influx of new money into the market. Similar results were observed in the other markets surveyed.

Though the findings resulting from the survey are preliminary, the Commission determined that certain constructive steps can and should be taken based on the survey results. As announced in the staff report, these measures include: (1) developing a more precise method of reporting for large traders conducting a mix of commercial and noncommercial activity to enable the Commission to better estimate the true nature of transactions occurring on exchanges; (2) creating a separate category identifying the trading of swap dealers for the weekly COT reports; (3) publishing a new periodic supplemental COT report of swap dealer activity that will provide a “look through” to their clients and identify the types and amounts of trading, including index trading, occurring through swap dealers; and (4) creating a new CFTC office devoted solely to data collection and dissemination. This office would implement new reporting procedures for large traders to allow staff to more accurately assess their trading activity. In addition, the Commission intends to review whether to eliminate the *bona fide* hedge exemption for swap dealers and to create a more limited risk management exemption for their on-exchange activity. The Commission also intends to review the independence of commodity research from the futures trading activities of large financial institutions. And finally, the report notes that the Commission will continue to promote policies that enhance and facilitate the clearing of OTC derivatives whenever possible.

It goes without saying, but I will say it anyway, that implementing this plan of action is going to take time and will require substantial additional resources for personnel and technology. The CFTC currently is operating at or near historically low staffing levels and will require an increase in funding to adequately meet its current mission and the expanded responsibilities I have outlined. Many, if not most of the legislative proposals introduced by Congress dealing with the role of speculators have also included additional appropriations for the CFTC. I am hopeful that Congress will find a way this year to make our funding a priority.

Needless to say, the first year of my tenure at the Commodity Futures Trading Commission has been a busy one. I am honored to be here in Tokyo with all of you and to have the opportunity to share some of the developments of the U.S. futures regulatory agency.