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 and Commissioner Michael Dunn
Commodity Futures Trading Commission
Before the Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate
July 9, 2007

Thank you, Mr. Chairman and members of the Subcommittee. On behalf of the Commodity Futures Trading Commission (CFTC or Commission), we appreciate the opportunity to discuss the CFTC, our role with respect to the futures markets, our view of the markets as the government regulator charged with overseeing them and your report's conclusions.

CFTC Mission

The CFTC's mission is two-fold: to protect the public and market users from manipulation, fraud, and abusive practices; and to promote open, competitive and financially sound markets for commodity futures and options.

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures markets, and later option markets, in the United States. To do this, the Commission employs a highly-skilled and dedicated staff who work within three major programs – Market Oversight, Clearing and Intermediary Oversight, and Enforcement. These divisions have distinct and separate charges and standards to meet, while working in conjunction to ensure market integrity and economic opportunity. The three major Commission programs are complemented by other offices, including the Office of the Chief Economist, Office of the General Counsel, Office of International Affairs and Office of Proceedings. The Chairman and Commissioners' offices provide agency direction, and stewardship over CFTC's human capital, financial management, and information technology resources. Given the Committee's interest in our exchange oversight operations, we'll begin by describing that function, and provide additional background on the Commission's other main operating divisions. I will address the Committee's questions and concerns relating to "excessive speculation" and oversight of exempt commercial markets, and conclude our remarks with comments on Amaranth and certain budgetary concerns relating to the Commission.

<u>CFTC Division of Market Oversight</u>

The Commodity Exchange Act (CEA or Act) provides that the Commission has exclusive jurisdiction with respect to accounts, agreements, and transactions involving commodity futures and options contracts that are required to be traded or executed on a designated contract market, also known as a "DCM" or an exchange. One of the purposes of the CEA is "to serve the public interests . . . through a system of effective self-regulation of trading facilities . . . under the oversight of the Commission."[1] DCMs are regulated entities that are self-regulatory organizations (SROs) subject to comprehensive oversight by the CFTC. DCMs can list for trading any type of contract, they can permit intermediation, and all types of traders (including retail traders) are permitted to participate in their markets. The CFTC's Division of Market Oversight (DMO) is responsible for monitoring and evaluating a DCM's operations and it conducts surveillance of all activity on DCMs, as described below.

DCMs must comply with a number of designation criteria and core principles as a condition for initial CFTC approval and continuing operation. Once operational, DCMs, as SROs, must establish and devote resources toward an effective oversight program, which includes surveillance of all activity on their markets to detect and deter manipulation and trading abuses. That responsibility includes, among other things, ensuring that listed contracts are not readily susceptible to manipulation, addressing conflict of interest situations, ensuring fair trading, providing for the financial integrity of contracts, utilizing effective rules to deal with market emergencies, and complying with comprehensive reporting and recordkeeping requirements. DMO staff review all exchange new product and rule filings to ensure that they comply with the core principles set forth in the Act and the Commission's regulatory requirements.

DMO's market surveillance mission regarding DCM activity is to ensure market integrity and customer protection in the futures markets. Traders establishing positions on DCMs are subject to reporting requirements so that DMO staff and the DCM can evaluate position sizes to detect and deter manipulation. In addition, trade practice surveillance involves compilation and monitoring of transactional-level data by the Commission and the DCM to detect and deter abusive trading such as wash sales, money laundering and trading ahead of customers (trade practice surveillance). The surveillance staff conducts active market and trade practice surveillance of all futures and options trading activity that occurs on DCMs.

Under the CEA, the primary mission of market surveillance is to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for the estimated 1,400 active futures and option contracts in the U.S., DMO market surveillance staff monitors the activities of large traders, key price relationships, and relevant supply and demand factors to ensure market integrity.

The market surveillance staff focuses, for example, on looking for large positions, especially in comparison to potential deliverable supply of the commodity. Such a dominant position might provide a trader an opportunity to cause a price manipulation, such as in a "squeeze," in which, for example, a single trader might hold a large long (buy-side) position and demand delivery of

[1] CEA Section 3(b), 7 U.S.C. § 5(b).

more of a commodity than is available for delivery. In such a situation, traders holding short (sell-side) positions may have no alternative but to buy back their positions at artificially high prices dictated by the dominant long trader.

The market surveillance program uses many sources of daily market information. Some of this information is publicly available, including data on: the overall supply, demand, and marketing of the underlying commodity; futures, option and cash prices; and data on trading volume and open contracts. Some of the information is highly confidential, including position and trading data that the Commission regularly receives from DCMs, intermediaries, and large traders.

DCMs report to the Commission the daily positions and transactions of each of their clearing members. The data are transmitted electronically during the morning after the “as of” trade date. They show separately, for proprietary and customer accounts, the aggregate position and trading volume of each clearing member in each futures and option contract. The data are useful for quickly identifying the firms that clear the largest buy or sell volumes or hold the biggest positions in a particular market. The clearing member data, however, do not identify the beneficial owners of the positions.

To address this limitation, DMO uses a large-trader reporting system. Under this system, clearing members, futures commission merchants (FCMs), and foreign brokers (collectively called “reporting firms”) electronically file daily reports with the Commission. These reports contain the futures and option positions of individual traders that hold positions above specific reporting levels set by Commission regulations, and allow DMO staff to review the beneficial owners of futures positions. If, at the daily market close, a reporting firm has a trader holding a position at or above the Commission's reporting level in any single futures month or option expiration, it reports that trader's entire position in all futures and options expiration months in that commodity, regardless of size.

Since traders frequently carry futures positions through more than one FCM, and since individuals sometimes control or have a financial interest in more than one account, the Commission routinely collects information that enables its surveillance staff to aggregate related accounts. Reporting firms file information with the CFTC to identify each new account that acquires a reportable position. In addition, once an account reaches a reportable size, the account owner periodically is required to file a more detailed report to further identify accounts and reveal any relationships that may exist with other accounts or traders.

Surveillance economists prepare weekly summary reports for futures and option contracts that are approaching their expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advises the Commissioners and senior staff of significant market developments at weekly surveillance meetings (which are non-public, closed meetings) so they will be prepared to take action if necessary.

Typically, the Commission gives the DCM, as the front-line regulator, the first opportunity to resolve any issue arising in its markets. If a DCM fails to take actions that the Commission deems appropriate, the Commission has broad emergency powers under the CEA to order the DCM to take specific actions. Such actions could include limiting trading, imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period, or closing a market. Fortunately, most issues are resolved without the need to use the Commission's emergency powers. The fact that the Commission has had to take emergency action only four times in its history demonstrates its commitment to refrain from intervening in the futures markets unless all other efforts have been unsuccessful.

In addition to market surveillance, DMO staff monitors trading activity on DCMs in order to detect and prevent possible trading violations. To help accomplish this mission, staff engages in various analyses to profile trading activity and conducts trade practice investigations. These functions require the collection of trade data and the ability to process those in various ways for further analysis. In this regard, DMO currently operates the Electronic Database System (EDBS), a system developed in the mid-1980s, to process and maintain information concerning trading activity on DCMs. EDBS is an older system with limited capabilities, especially with respect to trading data collected from electronically traded markets. The Commission is in the process of replacing EDBS with a more robust tool, the Trade Surveillance System (TSS). The primary function of TSS is to collect and make all trade data accessible to staff so they can retrieve, organize, and analyze trade data to assess DCM compliance with the Act and Commission regulations. TSS will assist staff in conducting timely, customized analyses of all trading activity; examining side-by-side trading (same contract trading simultaneously on an exchange floor and an electronic trading platform) and cross-market activity (similar or identical contracts trading on different exchanges); and detecting novel and complex patterns of potential trading violations involving electronic trading. TSS also will allow DMO staff to respond to fast-moving market events, which is crucial to effective trade practice surveillance. The identification of potential trading violations results in referrals to relevant DCMs and to the Commission's Division of Enforcement.

It should be noted that surveillance of DCM trading is not conducted exclusively by the Commission. As SROs, DCMs have significant statutory surveillance responsibilities.[2] Typically, however, surveillance issues are handled jointly by Commission staff and the relevant DCM. Surveillance information is shared and, when appropriate, corrective actions are coordinated. Situations of particular surveillance interest are jointly monitored and, if necessary, verbal contacts are made with the brokers or traders who are significant participants in the market in question. These contacts may be for the purpose of asking questions, confirming reported positions, alerting the brokers or traders to the regulatory concern regarding the situation, or warning them to conduct their trading responsibly. Throughout its history, the Commission, together with the DCMs, has been quite effective in using these methods to resolve issues at an early stage.

Another key DMO oversight role involves staff oversight and assessment of the regulatory and oversight activities of DCMs. This involves periodic examinations of DCMs' self-regulatory programs on an ongoing, routine basis to evaluate their compliance with applicable core principles under the Act and the Commission's regulations. These examinations, known as "Rule Enforcement Reviews," result in reports that evaluate a DCM's compliance and surveillance capabilities. The reports set forth recommendations for improvement, where appropriate, with respect to a DCM's trade practice surveillance, market surveillance, disciplinary, audit trail, and dispute resolution programs. These reviews promote and enhance continuing, effective self-regulation and ensure that exchanges rigorously enforce compliance with their rules. The reports are made public and are posted on the Commission's Website.

[2] *See, e.g.,* Sections 5(b)(2) and 5(d)(4) of the CEA, 7 U.S.C. §§ 7(b)(2), 7(d)(4).

In conclusion, the Commission has a comprehensive market oversight program to detect and prevent disruption of the economic functions of all the commodity futures and option markets that it regulates.

CFTC Division of Clearing and Intermediary Oversight

The Commission's Division of Clearing and Intermediary Oversight (DCIO) is responsibile for and plays an integral role in ensuring the financial integrity of all transactions on the markets that it regulates.

DCIO meets these responsibilities through an oversight program that includes the following elements: (1) conducting risk-based oversight and examinations of industry SROs responsible for overseeing FCMs, commodity trading advisors, commodity pool operators, and introducing brokers, to evaluate their compliance programs with respect to requirements concerning fitness, net capital, segregation of customer funds, disclosure, sales practices, and related reporting and recordkeeping; (2) conducting risk-based oversight and examinations of all Commission-registered derivatives clearing organizations (DCOs) to evaluate their compliance with core principles, including their financial resources, risk management, default procedures, protections for customer funds, and system safeguards; (3) conducting financial and risk surveillance oversight of market intermediaries to monitor compliance with the provisions of the CEA and Commission regulations; (4) monitoring market events and conditions to evaluate their potential impact on DCOs and the clearing and settlement system and to follow-up on indications of financial instability; and (5) developing regulations, orders, guidelines, and other regulatory approaches applicable to DCOs, market intermediaries, and their SROs. Collectively, these functions serve to protect market users, the general public and producers, to govern the activities of market participants, and to enhance the efficiency and effectiveness of the futures markets as risk management mechanisms. DCIO's most important function is to prevent systemic risk and ensure the safety of customer funds.

The DCOs that the Commission currently regulates are located in New York, Chicago, Kansas City, Minneapolis and London, England. The intermediaries overseen by the Commission are located throughout the United States and in various other countries.

CFTC Division of Enforcement

At any one time, the Division of Enforcement (Enforcement) is investigating and litigating with approximately 700 to 1000 individuals and corporations for alleged fraud, manipulation, and other illegal conduct. Working closely with the President's Corporate Fraud Task Force, Enforcement is staffed with skilled professionals who prosecute cases involving complex over-the-counter (OTC) and on-exchange transactions. Enforcement also routinely assists in related criminal prosecutions by domestic and international law enforcement bodies.

During the last five years, Enforcement has maintained a record level of investigations and prosecutions in nearly all market areas, including attempted manipulation, manipulation, market squeezes and corners, false reporting, hedge fund fraud, off-exchange foreign currency fraud, brokerage compliance and supervisory violations, wash trading, trade practice misconduct, and registration issues.

In the energy sector alone, Enforcement investigated Enron and dozens of national and international energy companies, as well as hundreds of energy traders and hedge funds around the country. As a result of those efforts, the Commission prosecuted numerous traders and corporate entities. At the same time, in other market sectors, Enforcement prosecuted more than 50 hedge funds and commodity pool operators for various violations, and filed actions against more than 360 individuals and companies for off-exchange foreign currency fraud and misconduct.

Enforcement receives referrals from several sources: the CFTC's own market surveillance staff; the compliance staff at exchanges; market participants and members of the public; and other State, Federal, and international regulatory authorities. During an investigation, the CFTC may grant formal administrative subpoena authority, which enables Enforcement to obtain relevant materials (for example, audio recordings, e-mail and trade data) and testimony from witnesses.

If warranted, at the conclusion of its investigation, Enforcement will recommend to the Commissioners that the CFTC initiate a civil injunctive action in Federal district court or an administrative proceeding. The CFTC may obtain temporary statutory restraining orders and preliminary and permanent injunctions in Federal court to halt ongoing violations, as well as civil monetary penalties, appointment of a receiver, the freezing of assets, restitution to customers, and disgorgement of unlawfully acquired gains. Administrative sanctions may include orders suspending, denying, revoking, or restricting registration; prohibiting trading; and imposing civil monetary penalties, cease and desist orders, and orders of restitution.

The CFTC also refers enforcement matters to the Department of Justice. Criminal activity involving commodity-related instruments can result in prosecution for criminal violations of the CEA and for violations of Federal criminal statutes, such as mail fraud or wire fraud.

CFTC Speculative Position Limits and "Excessive Speculation"

Under the CEA, the concept of "excessive speculation" is based on trading that results in "sudden or unreasonable fluctuations or unwarranted changes in the price" of commodities underlying futures transactions.[3] When Congress enacted the CEA in 1974, it included a number of statutory provisions specifically relating to market price distortions. Several of these provisions prohibit market manipulation, making it a violation of the Act to manipulate the price of a commodity in interstate commerce or for future delivery.[4] Congress also included an enabling provision stating that excessive speculation is a burden on interstate commerce.[5] This provision does not make excessive speculation a *per se* violation of the Act, but rather, requires the Commission to enact regulations to address such trading (for example, through speculative position limits).

The rationale for the distinction between manipulation and "excessive speculation" is two-fold. Manipulation of market prices is a clear and undeniable threat to the integrity of the marketplace and to the fundamental purposes of futures markets – risk management and price discovery – and there is a long-standing body of law defining the parameters of futures market manipulation.[6]

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[3] CEA Section 4a(a), 7 U.S.C. § 6a(a).
[4] CEA Sections 6(c), 6(d), 9(a)(2), 7 U.S.C. §§ 9, 13, 13b, 15.
[5] CEA Section 4a(a), 7 U.S.C. § 6a(a).
[6] *See, e.g., In the Matter of Indiana Farm Bureau Coop. Ass'n* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796 (CFTC 1982).

"Excessive speculation," on the other hand, is an undefined concept. Futures markets require both speculators and hedgers. Speculators provide the market liquidity to allow hedgers to manage various commercial risks. Placing limitations on the amount of speculation that an individual or entity may engage in necessarily limits the amount of liquidity in the marketplace and may limit the ability for hedgers to manage risks, and may limit information flow into the marketplace, which could in turn negatively affect the price discovery process and the hedging function of the marketplace.

Congress recognized the difference between these two concepts in enacting separate and distinct manipulation and excessive speculation provisions in 1974. Manipulation, a clear market threat, is a violation of the Act, while "excessive speculation" (a more ambiguous concept) is addressed by the CFTC exercising its regulatory expertise through rulemaking.

Accordingly, pursuant to Section 4a of the Act, the Commission has utilized its authority to set limits on the amount of speculative trading that may occur or speculative positions that may be held in contracts for future delivery. The speculative position limit is the maximum position, either net long or net short, in one commodity future (or option), or in all futures (or options) of one commodity combined, that may be held or controlled by one person (other than a person eligible for a hedge exemption) as prescribed by a DCM and/or by the Commission. Moreover, CEA Section 5(d)(5)[7] requires that an exchange, "to reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month . . . shall adopt position limitations or position accountability for speculators, where necessary and appropriate."

All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits – and many financial futures and options are as well. With respect to such exchange spot month speculative position limits, the Commission's guidance specifies that DCMs should adopt a spot month limit of no more than one-fourth of the estimated spot month deliverable supply, calculated separately for each contract month. For cash settled contracts, the spot month limit should be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or underlying commodity's price.

The focus on spot month position limits is because these are the futures months that are most vulnerable to manipulation. This vulnerability results, in general, from the fact that a futures contract at expiration must result either in physical delivery—which can be used to cause a squeeze—or in a final cash settlement—which can be manipulated by heavy trading that distorts the index used for the final settlement. These rules are designed to prevent traders from accumulating concentrations of contracts of a size that could potentially lead to manipulation or disrupt a market.

As part of its routine, ongoing surveillance program, Commission staff monitor daily large-trader reports to ensure compliance with Commission and DCM position limits. When market surveillance staff detect an instance of a position limit violation, it takes prompt remedial action to require the trader to reduce its position to be in compliance with the position limit. In instances of a violation of Commission position limits, market surveillance staff send a warning letter to the trader advising that the violation is considered a serious matter, and that any further violation could lead to formal action that could result in the suspension or denial of the trader's

[7] 7 U.S.C. § 7(d)(5).

trading privileges and assessment of a substantial fine. In instances of violations of exchange position limits, market surveillance staff refer the violation to the exchange and request to be advised of what action is taken in the matter. In instances of repeated violations of Commission and/or exchange position limits by a trader, market surveillance staff refer the matter to the Commission's Division of Enforcement for investigation and possible initiation of formal Enforcement action.

With respect to trading outside the spot month, the Commission typically does not require speculative position limits. Under the Commission's guidance, an exchange may replace position limits with position accountability for contracts on financial instruments, intangible commodities, or certain tangible commodities. If a market has accountability rules, a trader – whether speculating or hedging – is not subject to a specific limit. Once a trader reaches a preset accountability level, however, the trader must provide information about his position upon request by the exchange. In addition, position accountability rules provide an exchange with authority to restrict a trader from increasing his position if so ordered by the exchange.

Finally, in order to achieve the purposes of the speculative position limits, the Commission and the DCMs treat multiple positions held on a DCM's market that are subject to common ownership or control as if they were held by a single trader. Accounts are considered to be under common ownership if there is a 10 percent or greater financial interest. The rules are applied in a manner calculated to aggregate related accounts.

Violations of exchange-set or Commission-set limits are subject to disciplinary action, and the Commission, or a DCM, may institute enforcement action against violations of exchange speculative limit rules that have been approved by the Commission. To this end, the Commission approves all position limit rules, including those for contracts that have been self-certified by a DCM.

It is important to note that the fundamental thrust of the Commission's manipulation and excessive speculation provisions has not changed in any of the Commission's six reauthorizations since 1974. In other words, in the three decades since enactment of the Act, Congress has not determined in any one of its comprehensive reviews of the CEA, to make "excessive speculation" a *per se* violation of the CEA, but rather has continued to rely on the agency and the self-regulatory organizations to address excessive speculation through regulatory measures.

Oversight of Exempt Commercial Markets

Congress included a provision in the Commodity Futures Modernization Act of 2000 (CFMA) to govern a new type of trading facility known as an Exempt Commercial Market (ECM).[8] As outlined in Section 2(h)(5)(F) of the CEA, ECMs are not "registered with, or designated, recognized, licensed or approved by the Commission." ECMs, as well as transactions executed on ECMs, are statutorily exempt from most provisions of the CEA. Trading on an ECM such as the Intercontinental Exchange in Atlanta (ICE) is not subject to regular, ongoing market surveillance oversight by the Commission. Under current law, the Commission does not have the legal authority to limit the size of a trader's position on an ECM. Nor are ECMs required to comply with the self-regulatory obligations required of DCMs, such as adopting position

[8] CEA Sections 2(h)(3)-(5), 7 U.S.C. §§ 2(h)(3)-(5).

limitations or position accountablility rules. The Commission does retain fraud and manipulation authority over ECMs. To assist the Commission in carrying out its fraud and manipulation authority, ECMs are required to maintain a record of allegations or complaints received by the trading facility concerning instances of suspected fraud or manipulation and to forward them to the Commission.[9]

ECMs are also subject to certain limited reporting requirements that are authorized under Section 2(h)(5)(B)(i) of the CEA and spelled out in Commission Regulation 36.3(b).[10] Pursuant to these provisions, an ECM is required to identify those transactions conducted on the facility with respect to which the ECM intends to rely on the statutory Section 2(h)(3) exemption, and which averaged five trades per day or more over the most recent calendar quarter. With respect to such transactions, the ECM is required to transmit weekly to the Commission certain basic trade information, including "the commodity, the [delivery or price-basing] location, the maturity date, whether it is a financially settled or physically delivered instrument, the date of execution, the time of execution, the price, [and] the quantity."[11] The reports filed pursuant to Regulation 36.3(b) can provide Commission surveillance staff with information regarding price spikes or unusual divergence between the price of a commodity traded on an ECM and the price of a related commodity traded on a DCM. The Regulation 36.3(b) reports, however, do not require ECMs to identify the individual traders holding positions on the ECM.

In addition, an ECM must maintain for five years, and make available for inspection upon request by the Commission, records of its activities related to its business as an electronic trading facility, including audit trail information sufficient to enable the Commission to reconstruct trading activity, and the name and address of each participant authorized to enter into transactions on the facility.[12] Should the Regulation 36.3(b) reports, or other information obtained by surveillance staff (including information from futures market large trader reports), indicate a need for further information from an ECM, Section 2(h)(5)(B)(iii) of the CEA and Commission Regulation 36.3(b)(3) give the Commission authority to issue what is known as a "special call." Under the CEA, the Commission can obtain from an ECM "such information related to its business as an electronic trading facility exempt under paragraph [2(h)](3) . . . as the Commission may deem appropriate." The issuance of a special call to an ECM is simply an indication that the Commission's staff is seeking additional information. A special call, in and of itself, is not evidence of improper or illegal market behavior.

Finally, if the Commission determines that an ECM performs a significant price discovery function for transactions in the cash market for the commodity underlying any agreement, contract, or transaction traded on the facility, the ECM must publicly disseminate, on a daily basis, information such as contract terms and conditions, trading volume, open interest, opening and closing prices or price ranges, or other price information approved by the Commission.[13] To date, the Commission has not made such a determination.

In part due to the lessons learned from the fall of Amaranth, the CFTC has been regularly utilizing its special call authority to request information from ICE. This information assists us in

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[9] Commission Regulation 36.3(b)(iii), (iv), 17 C.F.R. § 36.3(b)(iii), (iv).
[10] 17 C.F.R. § 36.3(b).
[11] ICE has been submitting such trade data for natural gas transactions meeting the regulatory reporting threshold since January 1, 2005.
[12] CEA Section 2(h)(5)(B)(ii), 7 U.S.C. § 2(h)(5)(B)(ii).
[13] CEA Section 2(h)(4)(D), 7 U.S.C. § 2(h)(4)(D); Commission Regulation 36.3(c)(2), 17 C.F.R. § 36.3(c)(2).

the regulation of activities on DCMs, and we believe it helps us to get a more comprehensive picture of the marketplace, given the similarity of ICE's natural gas contracts to those traded on the New York Mercantile Exchange (NYMEX). On September 28 and December 1, 2006, respectively, the Commission issued two special calls to ICE that required ICE to provide position data to the Commission, on an ongoing basis, related to transactions in ICE's most heavily traded natural gas swap contracts. Specifically, these separately-issued special calls required that ICE provide the Commission with clearing member position data and individual trader position data in the various ICE natural gas contracts that are cash-settled based on NYMEX natural gas contracts.

The special call for clearing member position data was issued by the Commission on September 28, 2006, and the Commission has been receiving responsive data from ICE, on a daily basis, since October 10, 2006. The individual trader position data special call was issued on December 1, 2006. ICE found it necessary to make various technical adjustments to its systems in order to produce the requested materials, which it has done. Those adjustments are now in place, and the Commission received the first batch of individual trader daily position data on February 16 (showing positions as of February 15) and continues to receive that information on an ongoing basis.

These two special calls were issued primarily in order to assist Commission staff in its surveillance of the related NYMEX natural gas contracts. Compliance with special calls is not voluntary, but mandatory. The special calls were not issued as part of an investigation of any particular market participant or trading activity on either ICE or NYMEX. Nor were they issued in order to conduct regular market surveillance of ICE contracts themselves. The information provided by ICE through the special calls is comprehensive, but it does not duplicate the information that the Commission collects through its DCM surveillance programs.

Despite the difference in regulatory authorities over DCMs and ECMs, the Commission is aware that when markets trade similar products or products that can be arbitraged, information regarding activity in one market tends to be incorporated into the other. This is almost certainly the case when large numbers of traders operate in both markets, as is the case between NYMEX and ICE.

On the last trading day, NYMEX contracts are settled by physical delivery of natural gas, whereas ICE contracts are settled based on the NYMEX final settlement price. Because the ICE contracts settle off of the NYMEX price, it is clear that NYMEX prices affect ICE prices. It appears that price discovery in the natural gas contract may occur at both trading facilities. That is to say, information first affecting the ICE price is immediately conveyed to NYMEX and information first affecting the NYMEX price is immediately conveyed to ICE.

Given that price discovery may be conducted at both ICE and NYMEX, successful manipulation of the ICE price would be reflected in the NYMEX price. Arbitrage between ICE and NYMEX makes it possible for ICE prices to influence NYMEX prices. Since the Commission has not conducted a review of surveillance practices at ICE, our response cannot be as soundly based as would be the case were we asked about manipulation possibilities at NYMEX. However, the ability to manipulate prices on either has likely been reduced, given that ICE has broadened participation in contracts for natural gas.

Amaranth: CFTC Chief Economist's Overview

Understanding how the CFTC operates within its statutory authority is important when analyzing market events like the collapse of Amaranth in early fall of 2006.

In September 2006, funds managed by Amaranth Advisors, LLC, lost approximately $6 billion, or two-thirds of their value. The losses were due largely to Amaranth's natural gas positions at NYMEX and at ICE. As Figure 1 shows, Amaranth had positioned itself to profit on a widening difference between the prices of natural gas contracts expiring in the winter and natural gas contracts expiring in non-winter months. Such a strategy would have been profitable if prices for winter-delivery futures contracts had risen relative to prices for non-winter-delivery contracts.

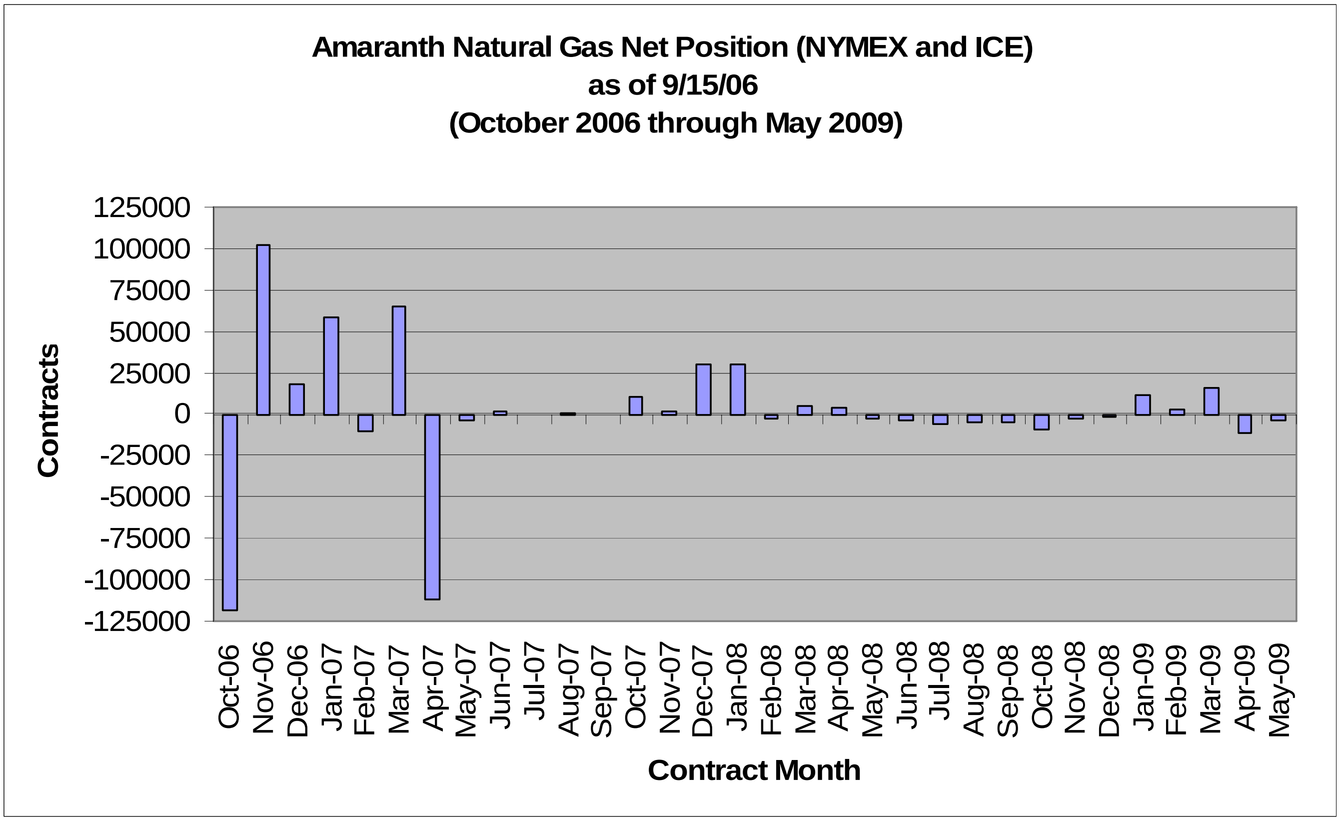

Figure 1.

Figure 2 illustrates one component of Amaranth's strategy. This Figure shows the spread position held by Amaranth in NYMEX natural gas futures contracts (and futures equivalent option contracts) for the delivery months of March and April 2007. The Figure shows that Amaranth held a "long" position in the March 2007 contract while simultaneously holding a "short" position in the April 2007 contract. Amaranth held a similar position on ICE. Amaranth began significantly ramping up this spread position in the spring of 2006. The difference between the March price and the April price is referred to as the "spread price," which is also displayed in Figure 2. As can be seen in the Figure, the spread price began to fall during the last week of August 2007. As the March/April spread fell from $2.50 per mmBTU in August to $.75 per mmBTU in mid-September, Amaranth's losses mounted.

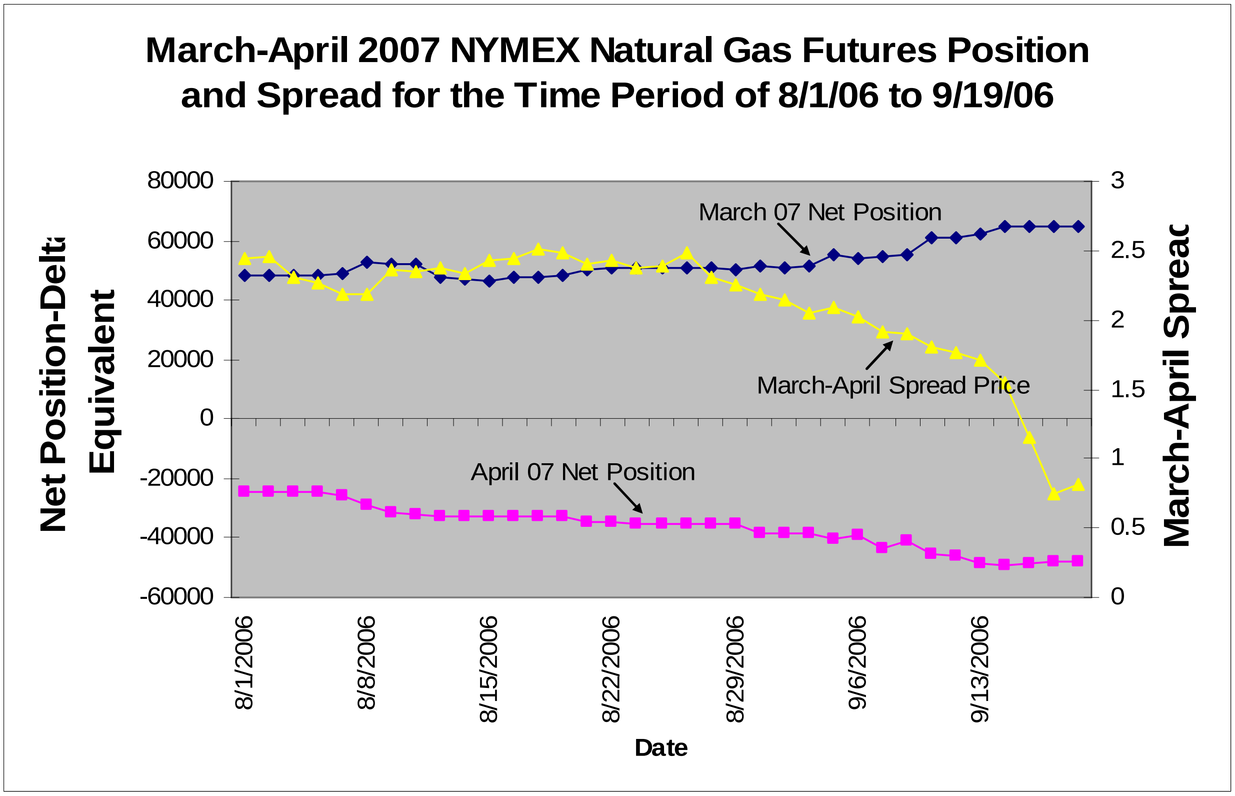

Figure 2.

After Amaranth's collapse, the CFTC's Office of the Chief Economist (OCE) analyzed the situation using statistical evidence. It is important to provide a historical context of the market in which Amaranth was operating. As can be seen in Figure 3, the unusually large level of the spread price began to appear around the time of Hurricane Katrina in 2005. The spread was the largest March/April spread ever observed. However, Amaranth did not begin accumulating its large position in the March/April 2007 spread until the spring of 2006. In other words, the March/April spread was at a historically high level for many months before Amaranth began accumulating its large March/April position.

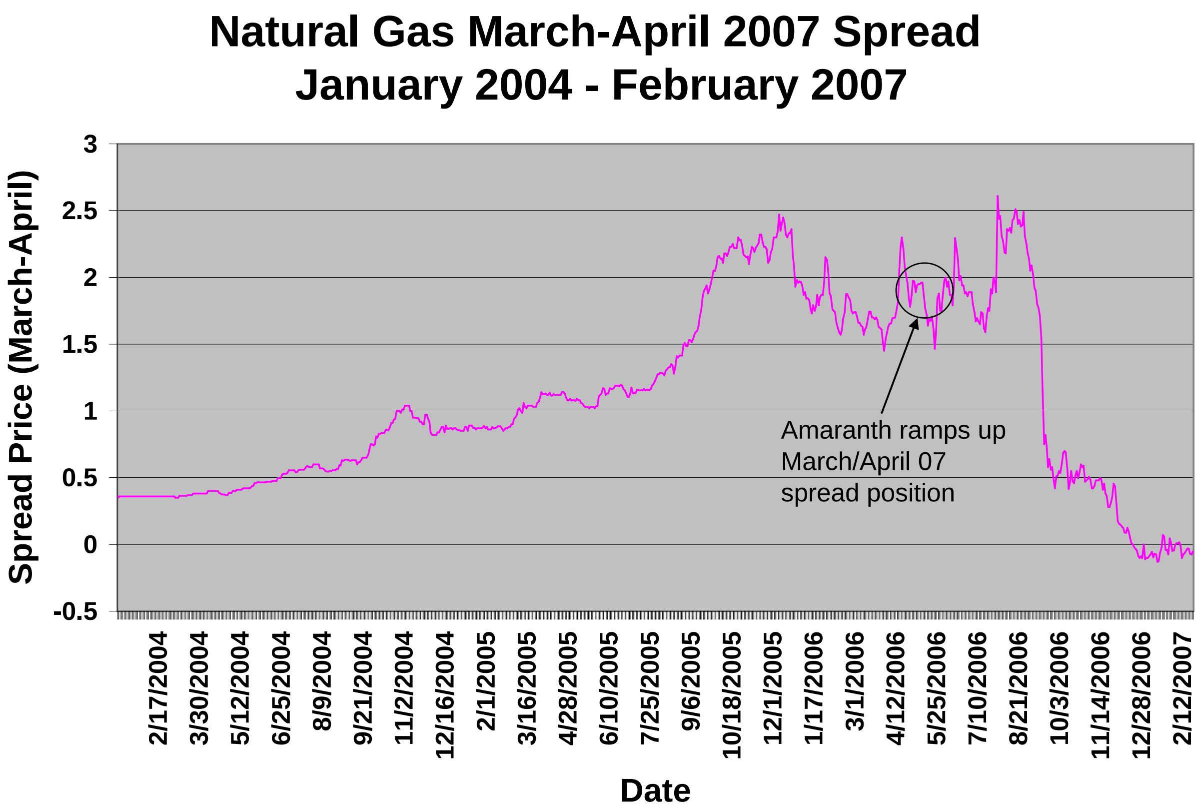

Figure 3.

The OCE analysis of Amaranth trading data failed to conclude that Amaranth's trading was responsible for the spread price level observed during 2006. The OCE analysis looked at the statistical relationship between changes in Amaranth positions, and changes in spread prices. In particular, the analysis focused on whether changes in Amaranth's positions caused short-term or longer-term changes in spread prices. The analysis found evidence of a causal relationship between changes in Amaranth's spread positions and changes in spread prices during 2006. Using a subset of 2006 data (April 15 to August 25) there is evidence of "two-way causality" – meaning that changes in Amaranth's positions influenced market prices at the same time changes in market prices influenced Amaranth's positions.

If Amaranth were dominating markets, OCE would have expected the statistical tests to have shown "one-way causality," where changes in Amaranth's positions would have influenced market prices but market prices would not have influenced Amaranth positions. That would have demonstrated statistically that Amaranth's positions were clearly driving the price. As noted above, OCE believes that Amaranth and the market appear to have been reacting to each other reciprocally.

On another point, interpreting open interest figures to discern market power, such as in the Committee staff report, requires special care. In futures markets, open interest is not a fixed level but can expand or contract depending on whether traders open or close contracts. Although Amaranth held the largest share of open interest, it was not holding a concentrated position of a fixed inventory of contracts. The market was completely open to other traders forming contracts at prices they found mutually agreeable. There were no barriers foreclosing the possibility of other traders entering the market. Because other traders were free to enter the market at any time, one must be cautious before concluding that Amaranth's level of open interest on one side of the market represented market power that dictated the level of the spread price.

Open interest represents trades made in the past. The futures price at any point in time is determined where a bid meets an offer. Open interest, by itself, cannot exert any influence on the prevailing level of bids and offers. Open interest can be an important factor in determining how a trader will behave in the future. For example, if it is known that a trader holds a large open position, other traders must consider the possibility that the large trader will change its position in the future.

In the OCE analysis, all of the data are consistent with the hypothesis that the March/April spread, and similar winter/summer spreads, declined due to changes in perception of market fundamentals. Amaranth established a large spread position that could only have been profitable if the unusually high spread price had become even more unusually high. Such a profitable scenario would have occurred if winter natural gas supplies had been disrupted by, for example, an active hurricane season in the Gulf of Mexico. In fact, the Gulf hurricane season proved to be less active than predicted, and instead of a widening price relationship between winter and non-winter natural gas futures contracts, the price difference narrowed considerably, resulting in significant trading losses to Amaranth.

There were particular dates in which changes in Amaranth's positions corresponded with temporary changes in spread prices. July 31 is one such date where the March/April spread price rose to an all-time high of $2.61 per mmBTU on the day that Amaranth significantly increased its position in this spread. However, the spread dropped back in the next trading session. Trading on this day was affected by a number of news stories about natural gas storage numbers (news released the previous day) and revised weather forecasts. Because of multiple events on this day it is difficult to attribute the spread increase to any one factor, including Amaranth's trading activity. If Amaranth was responsible for this temporary change in the spread price, the result is consistent with a story of a large trader trading in an illiquid market. Over time, sellers of the spread were attracted to the market and the spread price was quickly returned to a normal level for that time.

While OCE's economic analysis of what happened with Amaranth occurred after the fact, the Commission was aware of Amaranth's activities in the months leading up to September through our regular financial and market oversight surveillance.

JP Morgan Futures, a Commission-registered FCM was Amaranth's clearing broker at NYMEX. As the clearing broker, JP Morgan Futures was the NYMEX's counterparty for all positions that it cleared in the customer account with NYMEX, including the positions held by Amaranth. In the futures industry, customers have no legal relationship with clearing organizations and must eventually have all positions cleared and carried at clearing organizations, like NYMEX, by a clearing broker. Customers only have a legal relationship with their brokers. However, in exercising prudential risk management NYMEX also reviewed the positions and margin requirements of JP Morgan Futures' customers.

NYMEX staff periodically spoke with JP Morgan Futures staff about the Amaranth portfolio of cleared NYMEX positions. Under NYMEX rules, JP Morgan Futures was subject to capital based position limits. These rules limit the size of the positions a clearing member can carry in its proprietary and customer accounts according to the amount of capital it has. JP Morgan

Futures never exceeded these limits. Only ten to twelve NYMEX firms had sufficient capital to carry an account the size of Amaranth.

As part of its routine financial surveillance, Commission staff first contacted NYMEX staff about the Amaranth account in June 2006. When the Commission began receiving information about the losses experienced by Amaranth, the financial surveillance staff began actively monitoring the Amaranth account in early August 2006. Staff reviewed position information for NYMEX cleared products from the CFTC's large trader reporting system. Staff also reviewed information it received from NYMEX each day about the daily settlement and margin requirements for JP Morgan Futures.

Throughout this period, JP Morgan Futures met all of its obligations to NYMEX and staff had evidence that the Amaranth account at JP Morgan Futures was fully margined at all times during this period. Therefore, from a risk perspective, staff had no basis to recommend to the Commission that steps be taken to limit the size of Amaranth's positions. Further, staff had no evidence that the losses incurred by Amaranth would have significant negative impacts on other market participants.

Through its large-trader reporting system, the Commission is aware of the positions of all traders in all contracts traded on DCMs, such as NYMEX, that have positions above reportable levels. Accordingly, Commission staff was aware of the size of Amaranth's positions in natural gas contracts traded on NYMEX at all times during 2006. However, Commission staff was not aware of the size of Amaranth's positions on ICE until after Amaranth's announcement of substantial trading losses on September 18, 2006.

Commission market surveillance staff monitored Amaranth's compliance with NYMEX's position limit, position accountability, and hedge exemption rules. Commission staff was aware of NYMEX's action in early August 2006 to limit the size of Amaranth's NYMEX positions in the September, October, and November 2006 natural gas futures contracts. The Commission's staff was satisfied that NYMEX was properly monitoring Amaranth's position, and properly enforcing its position accountability rules. Commission staff did not view the size of Amaranth's NYMEX positions – especially in non-nearby futures months – as per se evidence of improper or manipulative trading. While natural gas forward curve spreads were unusual during this period, it was not at all clear that this was caused by excessive speculation. The summer of 2006 was forecast to be a very active hurricane season, and the market clearly remembered the devastating impact of the hurricanes of 2005 on the Gulf Coast's natural gas infrastructure, and the resultant sharp increase in winter month natural gas prices. Given this recent history and the forecast for another active hurricane season, it was certainly plausible that the unusual forward curve spreads incorporated a significant hurricane risk premium. Some market participants and observers may have believed that the risk premium was too high, but there was no apparent constraint preventing those holding such a view from incorporating that view into the price discovery process by selling the risk premium.

The Commission does not pick winners and losers in the futures markets based on any given trading strategy, but does work diligently – and did so in the case of Amaranth – to ensure market integrity and customer protections.

CFTC Budget

The current budget that funds the divisions, the technology and surveillance operations, and other support staff, is approximately $98 million for the current Fiscal Year (FY). The FY 2008 President's Budget request for the CFTC is for an appropriation of $116 million and 475 staff – an increase of approximately $18 million and 17 staff over the FY 2007 continuing resolution appropriation which supports a level of 458 staff.

We are grateful for the Administration's recognition of the need for increased funding for our agency. The FY 2008 Budget request is a good down payment in an effort to reverse a recent downward trend in resources at the Commission, but it is, in perspective, a small recognition of the challenge we face.

Since the CFMA was enacted, there has been a seven-fold increase in the rate of new product listings by U.S. exchanges. Nine new DCMs and nine new DCOs have been approved by the CFTC. Electronic trading has soared to approximately 60 percent of total volume this year, and that percentage is steadily increasing. The competition, product innovation, and increasing use of technology fostered by the CFMA meant exponential growth in the futures and option markets, especially during the last few years. It has also meant continuing evolution of these markets in the form of new trading venues, new trading strategies, new risk management tools, and new customers.

The CFMA replaced the prior "one size fits all" regulatory model with a flexible, practical, principles-based model for exchanges. U.S. exchanges also were given the authority to approve new products and rules through a self-certification process without prior CFTC approval, which encouraged innovation and enabled exchanges to act quickly in response to fast-changing market conditions. The CFMA also permitted the establishment of non-intermediated trading platforms such as ECMs, the growth of which has rapidly matured in recent years.

During this period of unprecedented growth for the futures industry, however, the CFTC's resources have been steadily diminishing. The CFTC needs additional staff resources in almost every program area. Currently, the Commission operates with a staff of 436 – an historic low at a time when the industry we regulate is at an all-time high by almost any measure: more volume, more trading platforms, more products, more complexity and a more global marketplace. Commission employees work hard, work smart, and use technology effectively, but given the complexity of the markets we oversee, they are stretched. We have the resources to carry out the Commission's mission on a daily basis – by asking more of staff and putting off some technological needs and other programs – but it is clear that the agency can continue at this funding level only for the short-term.

With regard to the adequacy of our surveillance resources, it is useful to consider that the number of actively traded contracts trading on U.S. exchanges has more than quintupled in the last decade, with most of that growth seen in the last five years. Staff devoted to surveillance today is 46; ten years ago, it was 58.

As for Enforcement, staff has fallen from 154 to 110 during the same ten-year period. The CFTC prides itself on its vigorous enforcement efforts. However, in derivatives markets that are exploding in size and complexity, coupled with its reduced staffing, the CFTC's enforcement professionals are struggling to keep up with the volume and size of its cases. For comparison purposes, the enforcement division at the Securities and Exchange Commission is funded with a budget that is more than twenty times larger than that for the CFTC's enforcement operations.

We are forced to make hard choices every day on how to prioritize our investigative and litigation efforts.

Technology is critical to enable our professional staff to adequately oversee the markets. However, budget constraints have required the Commission to put new systems development initiatives and hardware and software purchases on hold. For example, Commission investment in technology, as a percentage of total budget, has fallen from approximately 10 percent to around 7 percent. This trend is unsustainable given that so much of the growth in the futures industry is directly attributable to investments in technology. It is important that the Commission not be overwhelmed by the technologically innovative industry we regulate.

Conclusion

The CFTC's last reauthorization expired in 2005, and Congress has worked hard during the past two years to try to reauthorize the CFTC and update our statutory mandate. We appreciate the efforts of our authorizers, the Senate and House Agriculture Committees, as they continue those efforts.

A part of the reauthorization debate has been regulation of ECM energy markets. It is a complicated policy decision that encompasses consideration of a number of issues, including: economic opportunity and competition at home and abroad; ensuring customer protections and market integrity; promoting growth and innovation of U.S. exchanges; and ensuring a level playing field for competitors. Congress, regulators and industry participants have varied opinions on the topic and the debate continues. It is important to hear all sides to strike the right balance in this complex economic and policy discussion.

The futures markets have changed dramatically since the passage of the CFMA and the creation of the ECM category in section 2(h) of the CEA. This designation was intended to encourage innovation for these institutional markets while calibrating the amount of oversight to the risks associated with them. However, as the Subcommittee's staff report lays out, the regulated futures markets and exempt commercial markets have become increasingly linked and as a result, the public risks associated with these markets have changed. The CFTC has recognized this and exercised its existing statutory authorities in order to keep pace with industry growth, as needed. For example, through our ECM special call authority, the CFTC is obtaining the ongoing production of natural gas trading information from ICE because it helps us in our oversight of NYMEX, a regulated DCM, and helps to provide a more comprehensive picture of the marketplace. More recently, the CFTC proposed an amendment to clarify that our existing regulations require large traders on regulated DCMs to keep information relating to all their positions in the commodity subject to the reporting requirements – including information regarding transactions executed outside the regulated exchange – and to provide that information to the Commission upon request.

However, the agency is nearing the outer limits of its authority and it is appropriate to have this open dialogue with Congress and our fellow regulators about what other tools are needed to adequately oversee this marketplace and ensure fair competition and the integrity of the futures markets. Policymakers should be measured when considering additional regulation given these electronic markets can move offshore and have done so in the past. However, protecting the integrity of the price discovery process should be our utmost priority given its broad impact on consumers. The Commission continues to devote its resources and energies on addressing this important matter and looks forward to working with the Congress to ensure an appropriate amount of oversight.

This is truly a dynamic time in the futures markets, given the growth in trading volume, product innovation and complexity, and globalization – in all commodities, including energy. The Commission will continue to work to promote competition and innovation by proactively taking down unnecessary barriers to trading in our markets, while at the same time, fulfilling our mandate under the CEA to protect the public interest and to enhance the integrity of, and public confidence in, U.S. futures markets.

In closing, we appreciate the Committee's inquiries into this complex and important area. The Subcommittee staff report looks at a number of issues related to the CFTC and makes a number of recommendations and conclusions that warrant further debate, which we look forward to discussing with you.

Thank you.