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Reauthorization: Let the Debate Begin

By Walt Lukken, CFTC Commissioner

Authorization of the Commodity Futures Trading Commission (CFTC or Commission)—the independent federal agency that oversees the trading of futures contracts—will lapse on September 30, 2005.[1] Congress utilizes periodic reauthorization as a means for evaluating whether agencies and their statutes are meeting current policy and societal objectives. The last CFTC reauthorization—embedded in the Commodity Futures Modernization Act of 2000 (CFMA)[2]—resulted in the most significant reform of the Commodity Exchange Act (CEA) since the agency was created in 1974.

Congress has long distinguished between the laws that set forth federal policies (authorizing legislation) and the laws that fund such policy directives (appropriating legislation). Dating back to the 19th century, House and Senate rules have generally banned appropriating monies for non-authorized purposes and have subjected the legislation containing an unauthorized appropriation to a procedural point of order on the House and Senate floors.[3] In practice, however, these rules have several exceptions and are not strictly enforced, allowing many agencies to function for years without authorization.

Indeed, the CFTC has operated several times in the past without specific authorization, including most recently for several months in 2000 and for three years between the

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In This Issue

Authorization of the Commodity Futures Trading Commission will lapse on September 30, 2005. Some have questioned the value of periodic CFTC reauthorization. This article will discuss the lessons learned from the last reauthorization (as part of the Commodity Futures Modernization Act of 2000) as well as the several options available for Congressional consideration next year.

Reauthorization . . .

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years 1989 and 1992.[4] Should the CFTC's authorization expire next year without Congressional action, the doors of the agency would stay open and the statute would remain fully enforceable. However, this does not diminish the importance of the reauthorization process. Lawmakers on Capitol Hill have rightly approached reauthorization as an exercise in good government to ensure that the nation's laws, as well as the monies spent to enforce them, reflect the public interest. This remains a worthy public pursuit and one that Congress continues to take seriously.

Some have questioned the value of periodic CFTC reauthorization, given the enormous resources and time expended during the exercise by Congress, as well as the industry and the Commission. They note that other financial agencies, such as the Securities and Exchange Commission (SEC), are reauthorized more routinely and wonder why the CFTC doesn't fare the same. Ideas of a permanent reauthorization or a shorter time period between reauthorizations have been suggested. My personal view is that the current reauthorization process and schedule are appropriate because they reflect the existing confidence Congress has in our agency and the statute we enforce. Congress, with its full legislative agenda, does not want to spend time on legislative rewrites unless an agency is not fulfilling its public mission. With the CFMA as its oversight template, the CTFC has worked diligently the past several years to become a more respected and prominent member of the financial regulatory community and one that elicits the trust of the industry and Congress. If the CFTC continues on this path, as I hope it will, such enhanced perception and stature over time will inevitably lead to more routine reauthorizations and allow Congress to debate and enact policy changes for the CFTC only when they deem them timely and appropriate. Routine reauthorizations must be earned over time, not simply granted.

The House and Senate Agriculture Committees are the oversight and authorizing bodies of the CFTC and are principally responsible for drafting reauthorization legislation in 2005. Depending on the emergence of a significant market problem or trend, the appetite for change within the industry and the political dynamic in Washington, D.C., reauthorization may range from a one-line bill, as was the case in 1995, to an omnibus legislative effort, as was passed in 2000. This article will discuss the lessons learned from the last reauthorization as well as the several options available for Congressional consideration next year.

The Commodity Futures Modernization Act (CFMA)

On December 21, 2000, the Commodity Futures Modernization Act (CFMA) was signed into law. The CFMA's passage was somewhat miraculous given the political landscape at the time. The political dynamics were unprecedented in American history—the 2000 election was indeed a political "perfect storm." Just prior to the presidential election that year, Congress adjourned until after Election Day to finish its business for the year in a special lame-duck session. Instead of easing the legislative process, however, the election brought greater political uncertainties. The presidential contest resulted in a deadlock with no declared winner for over a month. With the Senate evenly split, the control of Congress also hung in the balance until a President was declared and the Vice President could assume the tie-breaking role of President of the Senate.

It should be of no surprise to those in the derivatives business that this environment of extreme political uncertainty would lead risk adverse individuals to hedge their bets. And that's what happened. The mid-December evening when a final legislative deal was struck on the CFMA was the same night that Vice President Gore conceded the presidential election. Within days, the CFMA passed as part of the final legislative vehicle enacted into law that year. While we now take for granted the progressiveness of the CFMA, it should not be forgotten that this legislation almost did not pass. As is the case with all reauthorizations, the scope of next year's reauthorization will be as much a question of politics as policy.

A major impetus behind the CFMA was to provide legal certainty for the over-the-counter (OTC) derivatives market by brightening the jurisdictional line of the CFTC to ensure that excluded derivatives transactions were not regulated as futures contracts. The regulatory structure of the CFTC had developed over the years around centralized exchanges that traded standardized futures contracts. OTC derivatives, however, are tailored transactions designed and brokered off-exchange for sophisticated counterparties through regulated Wall Street institutions. Although these products share risk-shifting attributes, other differences in function and characteristic made it apparent that the regulatory model for futures trading was ill suited for derivatives. Some feared that, without clarifications to the CFTC's jurisdiction, a court ruling that OTC derivatives were futures contracts had the potential to unravel this multi-trillion dollar market.

In 1999, the President's Working Group on Financial Markets (PWG)[5] provided a policy roadmap for clarifying the CFTC's jurisdiction in this area.[6] In determining the CFTC's authority, the PWG report looked to whether the products were being traded by retail customers, whether the products were susceptible to price manipulation and whether the participants were not otherwise regulated. Unless one or more of those factors were present in the market, the PWG believed there was no policy justification for CFTC oversight.

Within the CFMA, Congress incorporated the PWG's reasoning in several exclusions and exemptions for OTC derivatives and in the newly designed tiered regulatory structure for exchanges. The legislation excludes from our statute transactions in OTC derivatives when the transactions are in excluded commodities (generally, financial products) and occur between large, sophisticated parties. With no retail presence and little opportunity to manipulate this highly liquid and regulated financial marketplace, Congress believed excluding these transactions from CFTC oversight was justified.

The CFMA also exempts from certain provisions of the CEA OTC transactions in exempt commodities, which generally consist of energy and metal derivatives. Unlike statutory *exclusions,* where the CFTC retains no jurisdiction over transactions, an *exemption* retains for the CFTC certain residual authorities, primarily the CFTC's anti-manipulation powers and certain anti-fraud powers, while serving to clarify the areas of the law that no longer pertain to a given transaction. To qualify for the exemption, the markets must be limited to institutional participants trading in exempt commodities. Should the exempt market begin to function like an electronic exchange, the exemption requires that the exchange limit transactions to participants trading for their own accounts, notify the Commission of their activities, keep records, submit to CFTC's subpoena authority and information requests, and publicly report trade data when the products begin to serve a significant price discovery function. The theory behind this last requirement is that, once the broader marketplace begins to rely on prices discovered in exempt markets in interstate commerce, a federal interest arises to ensure that those prices are legitimate, transparent and free from manipulation. The CFTC recently published its final rule detailing the manner in which an exempt market becomes a price discovery vehicle and the requirements that follow such a determination.[7]

The CFMA also provided a new regulatory structure for the futures exchanges. Following the PWG's logic for exclusions, the legislation laid out differing tiers of regulation for exchanges, depending on the types of products being traded and the traders' level of sophistication. Futures on finite commodities that are offered to the retail public are required to trade under the most heavily regulated "contract market" designation, while those product markets that are less susceptible to manipulation and are offered only to sophisticated investors can benefit from a lower regulatory tier.

The CFMA also transitioned the regulatory structure of the CFTC from prescriptive rules and regulations to a principles-based approach. The CFMA set forth core principles that are meant to allow market participants to use different methodologies or "best practices" in achieving statutory requirements. Allowing the industry and self-regulatory organizations, rather than the Commission, to develop their own standards and guidelines was thought to better promote the practices reflective of the marketplace. The CFTC ultimately retains the authority to approve such practices, but the genesis for such guidelines is derived from the marketplace rather than the traditional top-down regulatory structure.

The CFMA also gives exchanges authority to self-certify new products and rules without prior CFTC approval. Self-certification enables exchanges to react quickly to competitive opportunities and threats. Congress believed the threat of foul play in this area was minimal because the interests of the exchanges were largely aligned with those of the public and where they were not, the CFTC retained the necessary authority to intervene.

The CFMA also lifted the 18-year "Shad-Johnson Accord" ban on futures on single stocks and on narrow equity indices, collectively known as security futures products (SFPs), and constructed a joint regulatory structure between the SEC and CFTC to oversee their trading. To avoid redundant regulation, the CFMA outlined a joint regulatory structure for SFPs that enabled exchanges and firms to choose a primary regulator and a notice or secondary regulator. This regulatory apparatus was meant to allow the notice regulator to exercise only those authorities that the primary regulator did not possess or those authorities that ran to the core mission of the respective agencies, such as insider trading for the SEC and market manipulation for the CFTC. Two exchanges, OneChicago and NQLX, registered to trade SFPs with the CFTC as their primary regulator and the SEC as their notice regulator. However, NQLX has announced that it will suspend trading in SFPs this December.

Post-CFMA Market Growth

Market data show that the derivatives markets have thrived since the CFMA's passage. By year-end 2004, volume on exchange-traded futures and options is expected to have grown by 164 percent since 2000.[8] This compares with a seven percent increase in the three years preceding the legislation. The OTC derivatives market has also grown exponentially since the CFMA's enactment with the notional value of contracts rising 107 percent.[9]

The number of competitors vying for exchange business has also increased dramatically since passage of the CFMA. Prior to its enactment in December 2000, there were 12 registered futures exchanges in the United States, a majority of which had been in existence since the 19th century. Since the CFMA's passage, the CFTC has designated eight additional futures exchanges as contract markets, and another 13 exchanges are qualified to operate as exempt markets subject to limited CFTC oversight. The

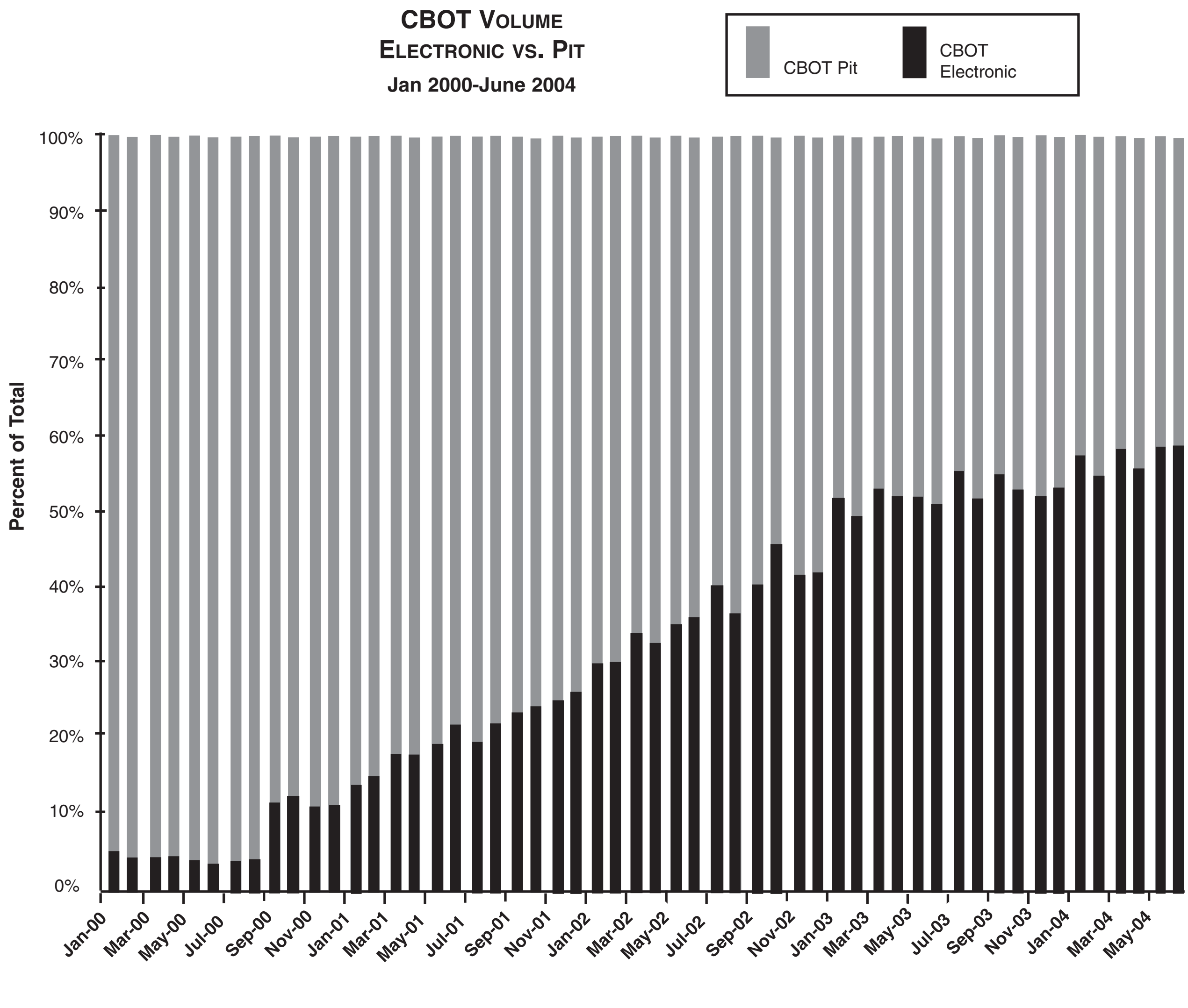
Commission has also registered eight derivatives clearing organizations since this category came into being with the CFMA.

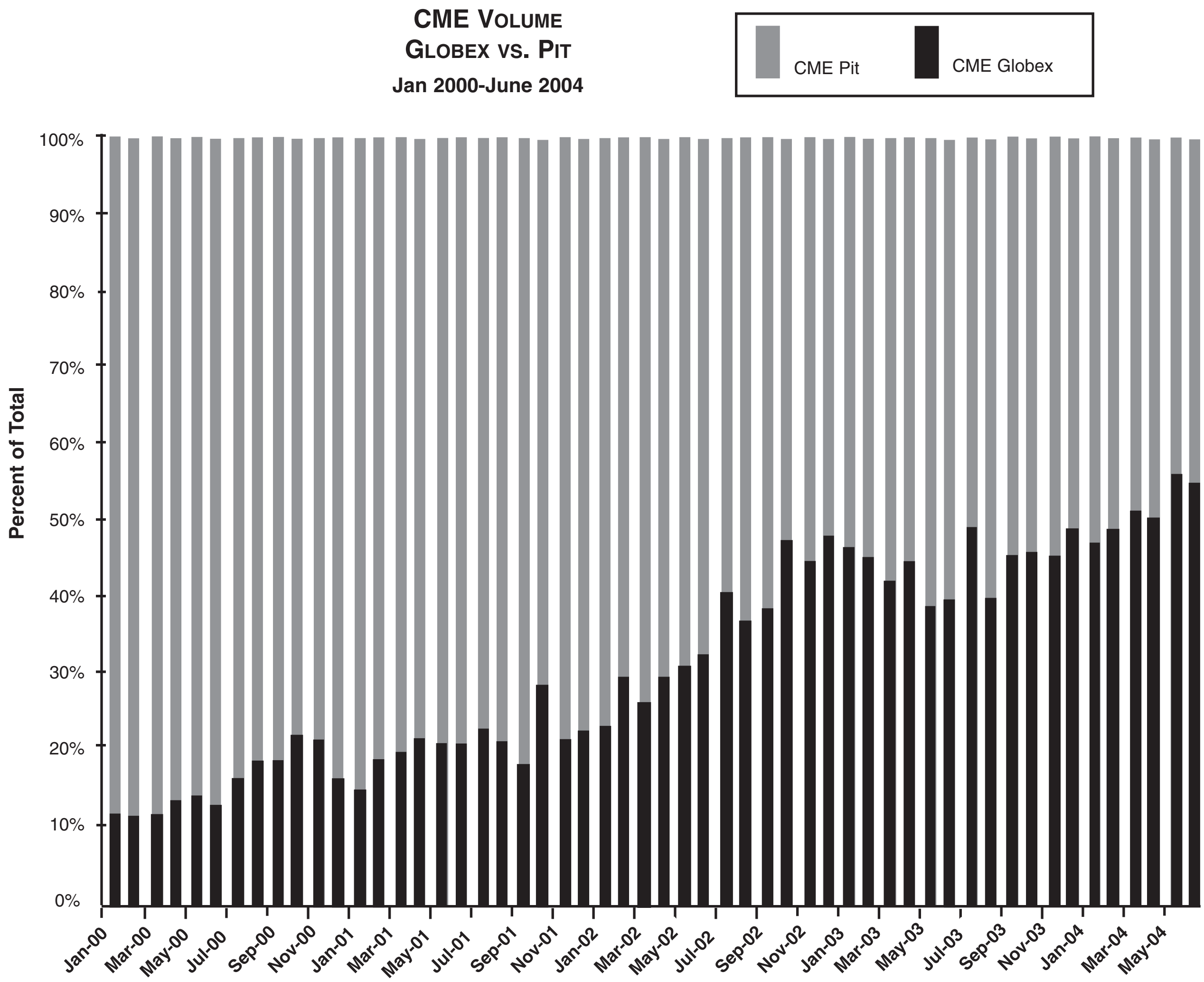
Product innovation has blossomed since 2000. The three years leading up to the CFMA saw 175 new products approved by the Commission with an average approval time of 90 days for futures contracts. Over 600 new products have been filed with the Commission post CFMA, with the vast majority being certified by the exchanges for immediate trading. Almost half of the new products listed have been SFPs made lawful by the CFMA.

These figures indicate that the regulatory barriers for exchanges have been lowered by the CFMA, and opportunities exist for enhanced innovation and competition to thrive in these markets. In fact, the world's largest derivatives exchange, Eurex, entered the U.S. market in February 2004 with the creation and designation of U.S. Futures Exchange (USFE). These competitive forces have resulted in major fee reductions within the industry as well as other cost saving measures by the major exchanges, including the joint Chicago Board of Trade/Chicago Mercantile Exchange "common clearing" venture, which is expected to save the futures commission merchant (FCM) community $1.4 billion in capital, and the accelerated migration of trading from pits to electronic, the latter of which now accounts for over half of the trading volume on U.S. futures exchanges. See Charts below. Clearly, competition appears to be healthy and beneficial to this market.

Changes for Reauthorization

It is important to understand that the CFMA's basic structure is a sound one. It is based on the fundamental recognition that regulators can neither effectively anticipate nor outmaneuver the competitive business environment in which the exchanges operate. In the past, many of the prescriptive rules written by the CFTC were outdated on the day they were published. This was not always the fault of the agency but the reality of the marketplace. The nature of these markets is to innovate, compete and arbitrage opportunities with lightning speed. In crafting the CFMA, policy





makers recognized that, instead of struggling against these attributes, a regulatory structure should be designed to leverage these market characteristics to the advantage of the public interest. The CFMA accomplishes this by matching the level of regulation to the product and type of participants, by deferring to the markets when their interests are aligned with the public, and by providing focused, flexible authority to the CFTC when its involvement serves the purposes of the CEA. This logic should remain the foundation of the statute.

The CFMA also made important clarifications to the Commission's jurisdiction by excluding certain OTC derivatives from its oversight. The PWG report made a strong case that the public interest would not be served by the CFTC's further regulation of this market. That reasoning remains equally valid today. The "legal certainty" provisions put in place for excluded derivatives should not be disturbed in the upcoming reauthorization.

That said, what changes should be contemplated during reauthorization? The following is a non-exclusive list of issues that may be ripe for consideration:

Self-Regulation

The self-regulatory system has served the futures industry well over the years but recent trends in this industry, including exchange demutualization, regulatory outsourcing and electronic trading, have brought a need to review its effectiveness. In May 2003, CFTC Chairman Jim Newsome tasked the CFTC staff to study our current self-regulatory system and make findings to the Commission. This call for a review was prescient, given last summer's governance troubles in the equity markets that raised concerns whether exchanges can effectively police themselves. Expected soon, the study's findings will provide important guidance to both the CFTC and Congress on whether the self-regulatory system needs adjustments. In fact, some of the exchanges—most notably the demutualized CME—have already made important changes to their board structure to eliminate conflicts between their regulatory functions and their profit centers.

Self-regulation should remain a complimentary part of our oversight structure. Its advantages outweigh its costs when the proper checks are in place. Self-regulation is justified and effective because exchanges have a vested interest in protecting their "brand name" and reputation. Self-regulatory organizations (SROs) also have proximity to the markets unlike government regulators, and can often act more quickly. Additionally, there are significant potential savings to the taxpayers in having the industry police itself.

However, the statute could be clearer regarding the objectives that are expected of SROs. Just as core principles provided public guideposts for contract markets and clearing organizations, self-regulatory core principles could serve a similarly important function. SRO core principles would provide exchanges, derivatives clearing organizations, and registered futures associations with concrete public directives while allowing them the flexibility to adhere to those goals in a manner that recognizes their specific needs. Just as important, a core principle approach would offer the CFTC greater guidance on its role and responsibility in overseeing this area. Such core principles should touch on the themes of decision-making independence for those individuals involved in the SRO process, transparency of the SRO rules and procedures to ensure fairness in adjudicating disputes, and methods for addressing conflicts of interest should they arise despite structural checks and balances. The public interest would be served by such delineated guidance.

CFTC Enforcement Authorities

With the CFMA shifting certain front-line regulatory functions from the CFTC to the exchanges, the Commission must be properly equipped in the enforcement arena to take swift action when wrongdoing is detected. "Real-time" enforcement has proven effective at punishing violators of our statute and at deterring further wrongdoing with minimal impact on legitimate market participants.

Unfortunately, the realities of today's marketplace have outpaced the statute that governs it. The CFTC's current fraud authorities were designed at a time when intermediated trades for open-outcry exchanges were the only game in town. Today, many of the new electronic futures exchanges are not conduits for brokered transactions. Rather, they facilitate direct trades between buyers and sellers. Yet some readers of our statute have asserted that its anti-fraud authority applies only to intermediated trades—the infamous "for or on behalf of" language.[10] There are no persuasive policy arguments that I have heard against Congress clarifying that the CFTC's fraud authority extends to all futures trading, including non-intermediated transactions. Fraud is fraud, whether there is a middleman or not.

The California energy crisis also highlighted the need for clarifications to the CFTC's false reporting and manipulation authorities for exempt energy trading. To the credit of the CFTC enforcement staff, our agency has used its current authorities to file 21 enforcement actions against companies and individuals in the energy sector for wrongful trading activity, which has resulted in civil monetary penalties in excess of $252 million, including a $35 million settlement with Enron. These results, on their face, indicate that our agency has substantial authority in this area. However, some have alleged that the CFTC's statutory authorities are imprecise and there remains legal uncertainty to whether exempt energy transactions are subject to the CFTC's fraud, false reporting and manipulation authorities. In response to these assertions, the House and Senate included consensus language in the stalled energy bill conference report to clarify the CFTC's oversight in this area and the applicability of these authorities. This language also included a fix to the "for or on behalf of" fraud language mentioned earlier. If these provisions are not enacted beforehand, Congress should explore including similar language in the CFTC reauthorization to ensure these markets are appropriately policed.

Furthermore, increasing the maximum statutory penalty levels in the CEA would be valuable for ensuring that violative behavior is adequately punished and sufficiently deterred. Maximum penalty figures have not been amended statutorily since 1992 and deserve a full review. The case for raising these levels is well justified given the increasing importance of both the futures and OTC derivatives markets to our overall market economy and the need to protect their integrity from wrongdoers. With the CFTC's increased reliance on real-time enforcement, higher penalties would effectively enhance the Commission's arsenal in policing these markets.

Retail Foreign Currency Fraud

Although the CFMA made significant progress with the CFTC's jurisdiction over retail foreign currency futures transactions, additional clarifications should be considered. The policy behind the PWG's recommendation in this area was simple: the CFTC should have fraud authority over retail foreign currency futures transactions unless another financial regulator otherwise oversees those transactions. This language was meant to ensure a seamless legal overlay in which these transactions did not face duplicative authority or fall between the regulatory cracks.

Since these legislative clarifications in 2000, the CFTC's enforcement division has been aggressive in its pursuit of forex bucket shops. It has been awarded $191 million in civil penalties and restitution in forex scams, involving more than 6,300 victims. Nevertheless, some have argued that certain wording in the law has brought uncertainty to whether intermediaries who fraudulently solicit the retail public to purchase these products where a regulated FCM acts as counterparty to the transaction should be subject to the CFTC's fraud authority. Allowing intermediaries to skirt the CFTC's fraud authority in this manner would seem to defy the logic behind this section. Clarifying this and the other legal uncertainties of this section should be a priority in reauthorization in order to meet prior Congressional intent and ensure that all the loopholes are closed for fraudulent activity in this area.

Security Futures Products

With almost two years of SFP trading having elapsed, Congress should explore whether its joint regulatory structure is working as intended. Are the SEC and CFTC meeting their core missions while effectively coordinating their investigations, audits and information sharing? Are the regulations properly tailored to address the risks to customers and exchanges? Is there a more efficient method for overseeing this developing marketplace? If Congress finds that the joint structure is not functioning properly, a range of options is available to consider, including streamlining the jurisdictional tests for the products and adjusting the specific roles of each agency. However, any changes in this area promise to be thorny, given how difficult it was to reach an agreement in 2000 and the several Congressional committees that would be involved in such reforms.

Regardless, one issue that should be addressed is foreign SFPs and futures on broad foreign indices. The CFMA required that the CFTC and SEC draft joint rules to allow U.S. customers access to futures on foreign broad-based equity indices and SFPs, either offered overseas or domestically by U.S. exchanges. Despite attempts, the agencies have yet to develop these regulations. Failure to promulgate a distinct regulatory path for foreign broad-based indices and SFPs has denied U.S. customers the ability to efficiently access foreign capital markets and has resulted in a disparity of treatment between "grandfathered" products that are allowed to trade due to their existence at the time of the CFMA's passage and similar foreign index products that have no regulatory means for U.S. approval. Congress could jump start these proceedings by providing more detailed legislative criteria in this area, by setting a date certain to complete the regulations and by providing sufficient legislative history to ensure that the joint rules reflect its intent.

Another issue that may be disproportionately impacting the success of the SFP market is its margin levels. The CFMA requires, and joint regulations reflect, that margin for SFPs be "consistent with comparable options," and "not […] lower than the lowest level of margin, exclusive of premium, required for any comparable option."[11] As a result, margin for SFPs are set at 20 percent of the current market value of the contract to ensure competitive parity between the options and SFP markets.

Broadly speaking, the futures and securities industries use the term "margin" very differently. "Margin" for the futures business means a performance bond intended to cover a one-day move of the underlying futures position. The margin levels of the futures industry are based on the specific volatility of a product and set by exchanges using historical price movements. "Margin" in the securities world is a much different animal used for collateral in purchasing securities. These securities margin levels are set by statute and regulation and are not risk-based or product-specific.

With credit and financial exposures similar to futures contracts, it would seem logical that regulators focus on the specific risks and volatilities associated with holding certain SFP positions and set margin requirements accordingly. For example, the following chart depicts the 20 percent margin requirements for SFPs on Microsoft compared to actual daily percentage price changes over time. The 20 percent initial margin level for this product, as well as with almost all SFP contracts, appears excessive given the minimal percentage price changes for this instrument. Without increasing the risks to customers or the market, policy makers should consider adjusting these margin levels to better reflect the specific volatility price risk of a given SFP.

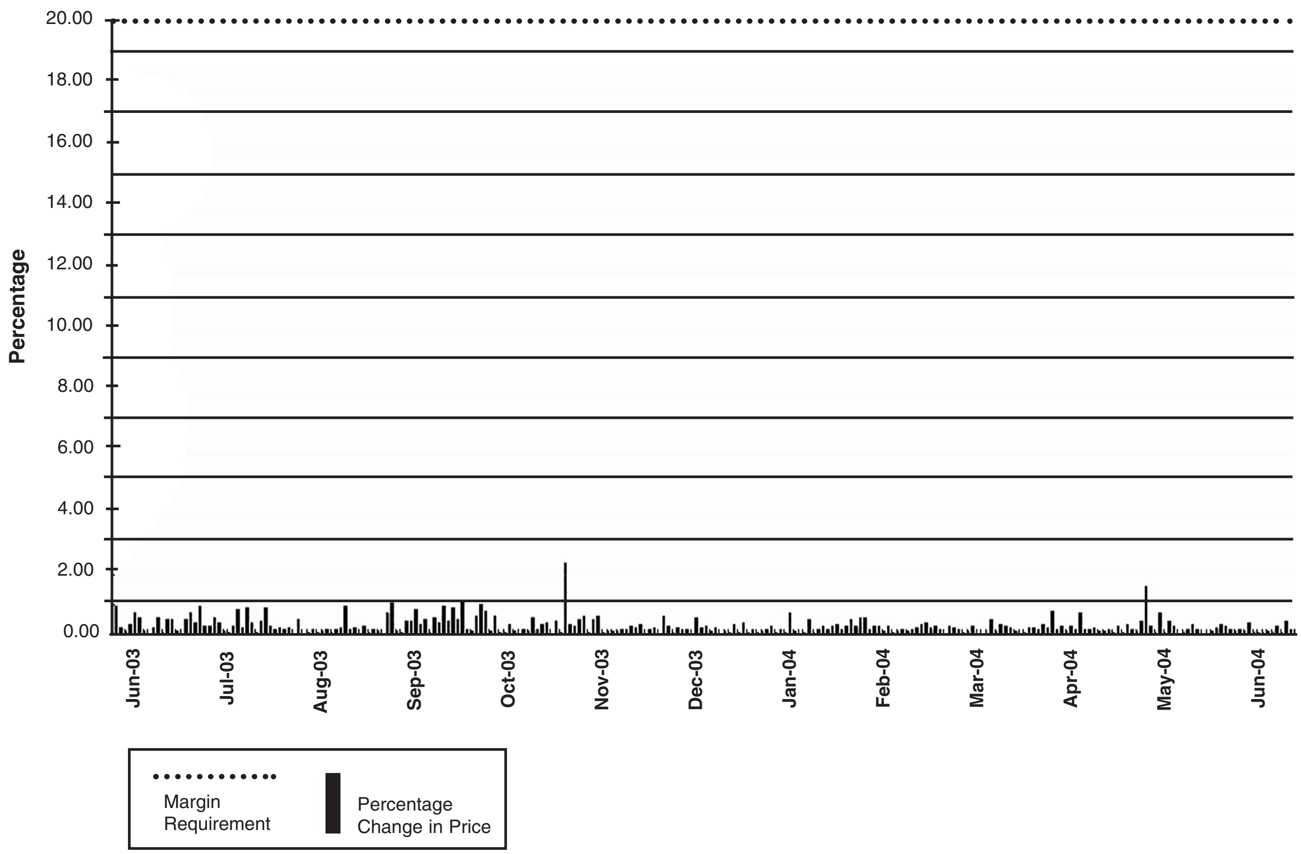
In addition, Congress should explore allowing this market to fully utilize portfolio margining. Today's futures markets extensively employ portfolio margining, which enables an FCM to lower its overall margin amounts by offsetting positions in the same underlying commodity class against each other. Just as individuals may lower their investment portfolio risks by diversifying their holdings, firms in the futures business utilize portfolio margining to lessen their total performance bond margin requirements. This is compared to strategy-based margining used by customers in the securities markets, which does not allow for such offsets. Given the broad acceptance by domestic and global financial regulators of portfolio margining and its significant use in the futures community, its allowance for SFPs would provide this marketplace with an enhanced opportunity for success without increasing the risks to the public.

"Spring Cleaning"

The CEA is one of the most poorly drafted statutes in the U.S. Code. Its arrangement is disorganized, it lacks subtitles in many areas, and it contains confusing section headings, including 4(a) versus 4a and 6a versus 6(a). Other parts of the CEA are moot and should be deleted. Without changing a substantive word of the statute, Congress could do a great service for the public by reorganizing the CEA to meet modern legislative drafting standards. I realize this is an ambitious idea and lawyers who practice in this area might loudly object. However, laws should be drafted in a manner that is clear, concise and organized for the understanding of the markets, its legal community and the public. This task would be difficult but worthwhile.

DAILY PERCENTAGE CHANGES IN SETTLEMENT PRICE AND MARGIN LEVEL FOR ONE CHICAGO MICROSOFT FUTURES CONTRACTS

June 2003-June 2004



Conclusion

Periodic reauthorization serves as a healthy exercise for the industry and its regulators. There is always significant inertia to overcome when passing legislation, especially on complex issues such as these that lack political appeal, and at the end of the day, lawmakers may decide on a one-line reauthorization. However, should policy changes be desired, the probability of legislative success increases substantially when, in addition to some fortunate political circumstances, the industry and its regulators work with Congress to develop a consensus piece of legislation that furthers the competitiveness and integrity of the futures industry. At a minimum, the experience of the CFMA has taught us that lesson. ■

1 Commodity Exchange Act (CEA) § 12(d), 7 U.S.C. § 16 (2003).

2 Commodity Futures Modernization Act of 2000 (CFMA), Pub. L. No. 106-554, 114 Stat. 2763 (December 21, 2000).

3 *See CBO Report, Unauthorized Appropriations and Expiring Authorizations, January 15, 2004 (Senate version).* Rule 21 of the House of Representatives and Rule 16 of the Senate generally prohibit the inclusion of unauthorized appropriations in appropriation and other legislation. However, these rules are not self-enforcing. Members of each body must raise a point of order at the appropriate time to enforce the rules. If a point of order is not raised, the unauthorized appropriation will continue through the legislative process.

4 The CFTC has operated without authorization five times during its 30-year history: from September 30, 1982 to January 11, 1983; from September 30, 1986 to November 10, 1986; from September 30, 1989 to October 28, 1992; from September 30, 1994 to April 21, 1995; and from September 30, 2000 to December 21, 2000.

5 President Reagan created the PWG by Executive Order 12631 after the stock market crash of 1987 to facilitate an open dialogue among federal financial regulators when inter-market issues arise. The Secretary of the Treasury chairs the PWG and its membership includes the Chairman of the Federal Reserve Board, the Chairman of the SEC and the Chairman of the CFTC.

6 *Report of the President's Working Group on Financial Markets: Over-The-Counter Derivatives Market and the Commodity Exchange Act*, November 1999 (hereinafter cited as *PWG Report)*.

7 69 Fed. Reg. 43,285 (July 20, 2004).

8 Futures Industry Association comparison of annual volume of futures and options trading for 2000 (594.5 million) through 2004 (estimated 1.569 billion).

9 The Bank of International Settlements (BIS) reports that the notional value of OTC derivatives as of December 2000 was $95.2 trillion. As of December 2003, BIS states in its latest report that the notional value of OTC derivatives stood at $197.1 trillion.

10 CEA § 4b, 7 U.S.C. § 6b(2003).

11 Securities Exchange Act of 1934, § 7(c)(2)(B)(iii)(I) and (II), 15 U.S.C. 78g(c)(2)(B)(iii)(I),(II)(2004).