Written Testimony of Acting Chairman Walter Lukken

Before the Subcommittee on General Farm Commodities and Risk Management

Committee on Agriculture
U.S. House of Representatives

October 24, 2007

Good morning Chairman Etheridge, Ranking Member Moran and Members of the Subcommittee. I am pleased to appear on behalf of the Commodity Futures Trading Commission (Commission or CFTC) to discuss the important issues surrounding the reauthorization of the Commodity Exchange Act (CEA), the Commission's governing statute.

Seven years have passed since the passage of the Commodity Futures Modernization Act (CFMA). During that expanse of time, significant change has occurred within the futures industry. In the past seven years, the annual volume on U.S. futures exchanges increased 442 percent. This industry has witnessed accelerated migration from open outcry trading to electronic platforms, with screen-based trading now accounting for a significant majority of all futures volume. New exchanges are created and new products are invented on a daily basis. But perhaps the greatest shift in the futures industry is the undeniable fact that our markets are global. Advances in technology have expanded the playing field to include every place in which there are people who wish to participate. For firms and exchanges, this is welcome news – more growth opportunities than ever before. For the marketplace, it means increased liquidity and information coming into the price-discovery process. But for regulators, this global repositioning means we must rethink how we do our jobs and adapt appropriately.

Thankfully, with the passage of the CFMA, Congress had the foresight to provide this agency with the flexible tools needed to oversee this rapidly changing marketplace. Before the principles-based regime implemented by the CFMA, some of the prescriptive rules written by the CFTC were virtually outdated on the day they were published. This was not 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, policymakers recognized that, instead of struggling against this dynamic, a regulatory structure should leverage these market characteristics to the advantage of the public interest and allow the agency to better anticipate change.

Much has been made of the flexibility provided businesses by the CFMA, but the adoption of a core principles approach equally enhanced the Commission's ability to get in front of developing regulatory problems. At a time of scarce resources, this has allowed the CFTC to target our efforts effectively to areas where the risks to the public are greatest. Although global growth has made the agency busier now than at any time in its history, the principles-based approach adopted in the CFMA has been remarkably

dynamic. I am pleased to report that, by and large, the legal framework of the Act is working extraordinarily well and no major revisions of the Act are needed.

That said, regulators and lawmakers cannot anticipate every evolution of these markets. With this recognition, I come before you today to discuss two broad areas on which Congress may wish to focus during the reauthorization process. First, based on recommendations from the Commission presented today, Congress may wish to evaluate whether enhancements are necessary for the legal framework provided for exempt commercial markets. Second, Congress may want to review whether the CFTC has clear and adequate authority to police fraud, particularly in the foreign currency area, and whether the penalty scheme for market manipulations reflects the severity of this economically disruptive behavior.

Exempt Commercial Markets

The CFMA created a tiered regulatory structure for the futures industry, which tailored regulatory requirements to the specific risks of the marketplace. This calibrated structure has provided the CFTC with flexibility and focus as we strive to keep pace with this industry's global growth.

Within this tiered design, Congress created a light-touch regulatory category called Exempt Commercial Markets or ECMs, on which certain commodities, such as energy products, could be traded by institutional participants. Due primarily to the non-retail nature of these markets and the types of transactions executed, policymakers believed the risks associated with these institutional exchanges were low.

However, the energy markets have changed dramatically in these seven years and the Commission's regulation of these markets should evolve in kind. Although these exempt markets have increased competition and lowered costs for derivatives trading, certain energy contracts offered on ECMs now function as virtual substitutes for contracts listed on regulated exchanges, with tight correlation and linking of prices and participants.

With this as a backdrop, last month the Commission convened a hearing to examine the oversight of trading on designated contract markets (DCMs) and ECMs. Commission staff, exchanges, ECMs, and industry and consumer groups testified before the Commission in a productive debate of the relevant issues. Based on this hearing, the Commission presents to this Committee a report detailing the Commission's findings and recommendations regarding these energy markets.

Today, I want to highlight some aspects of the Commission's hearing and the resulting findings and recommendations. As the Committee knows, Section 3 of the Commodity Exchange Act provides that the public interest is served through the proper regulation of markets that serve a price discovery function in interstate commerce. Price discovery is the key determinant to Commission regulation and oversight, as others outside the marketplace begin to use prices to conduct business, such as farmers, utilities

and others. Similarly, price discovery was the primary focus of this agency when the Commission began its review of the regulatory structure of ECMs.

Although ECMs have been evolving over time, the relatively recent linkage of ECM contract settlement prices to DCM futures contract settlement prices raises the question of whether the CFTC has the necessary authority to police these markets for manipulation and abuse. Linkage of contract settlement prices was not contemplated at the time of the CFMA nor at the time of the Commission's 2004 rulemaking regarding ECMs that perform a significant price discovery function. The CFTC staff is concerned that ECM cash-settled "look-alike" contracts could provide an incentive to manipulate the settlement price of the underlying DCM futures contract to benefit positions in the "look-alike" ECM contract.

Testimony from the Commission's hearing and staff analysis on this subject has led us to conclude that one ECM, the InterContinental Exchange (ICE), is serving a significant price discovery role and that ICE and the New York Mercantile Exchange (NYMEX) function as virtual substitutes for each other in certain key products. Not only are the products substantially identical in terms and pricing, but the market participants are also the same, with all of the top 25 natural gas traders on NYMEX also trading significantly on ICE. Moreover, economic analysis by our staff indicates that the trading activity in these products on ICE serves a significant price discovery function on 20 percent of the trading days measured.

Many witnesses from the hearing testified that ECMs provide a valuable platform for markets seeking a low-cost, effective "on-ramp" to launch new ideas for contract design and trading methodologies. ECMs serve as incubators for new concepts and provide robust competition with DCMs. This competition has spurred established DCMs to respond to ECM initiatives with innovations of their own, whether it is developing new products or accelerating the pace of automation.

However, the reality that some ECM contracts are serving a significant price discovery function leads the Commission to conclude that changes to the CEA are necessary in order for the Commission to detect and prevent manipulation in these markets.

It is critical that any legislative changes should not result in stifling the innovation and other benefits brought about by ECMs, that changes should not overcomplicate an already complicated statutory regime set out in the CEA, and that changes should be cost-effective for the Commission and industry to implement.

To that end, the Commission recommends that the CEA be amended such that, upon a determination that an ECM futures contract serves a significant price discovery function, the Commission would have four new authorities: 1) Require large trader position reporting for that contract; 2) Require an ECM to adopt position limits or accountability levels for that contract; 3) Require an ECM to exercise self-regulatory

responsibility over that contract in preventing manipulation; and 4) Provide the ECM and the Commission with emergency authority over that contract.

These recommendations have the support of the entire Commission and will allow the agency to oversee price discovery contracts while keeping in place the tiered regulatory structure that has fostered the innovation necessary for U.S. markets to compete effectively in the highly competitive global marketplace. As a member of the President's Working Group on Financial Markets (PWG), I have fully consulted with my colleagues on the PWG regarding these recommendations.

In its report, the Commission recommends two other steps to keep abreast of the developing energy markets. First, the Commission recommends the agency establish an Energy Markets Advisory Committee to conduct periodic public meetings on issues affecting energy producers, distributors, market users and consumers in attempt to facilitate discussion and policy decisions as these markets evolve.

Second, the Commission proposes that the CFTC and the Federal Energy Regulatory Commission (FERC) work together to develop best practices for utilities and others who use NYMEX settlement prices as benchmarks in pricing their energy products. Our agencies should also help develop best practices for these end users of energy on how to utilize the futures and other derivatives markets in managing price risk and volatility.

Today, the Commission also announced its finalized its amendment to Regulation 18.05 clarifying its ability to obtain information from large traders in regulated markets regarding the full scope of their related positions, including over-the-counter transactions. This transparency serves as an important complement to the recommendations advanced today.

I am confident that the Commission proposal strikes the right balance of ensuring that these markets remain free of manipulative conduct while allowing the markets to grow and innovate on U.S. soil.

The *Zelener* Decision/Foreign Currency Fraud

In our commitment to protecting market participants and market integrity, I want to turn to the issue of retail fraud in foreign currency trading. In 2004, the Seventh Circuit Court of Appeals curtailed the Commission's ability to combat retail off-exchange foreign currency (forex) fraud. In the *Zelener* case, the court held that the contracts at issue were not futures contracts, but rather a type of spot contract that could not be the basis for a CFTC fraud action. This has provided a potential road map to scam artists as to how to deceive innocent retail customers while evading enforcement by the CFTC.

The CFTC believes that the *Zelener* case and others that have followed it were incorrectly decided and that the contracts at issue are futures contracts. Rather than continue to expend scarce Commission resources litigating this issue, however, we

present to Congress the opportunity to restore legal certainty by clarifying the CFTC's jurisdiction in this area.

In the last seven years, the CFTC has brought 98 enforcement actions involving forex fraud against unsuspecting retail customers. In these 98 cases, there were approximately 26,000 victims who invested approximately $461 million. Courts have awarded more than $1 billion ($1,000,917,086) in customer restitution and civil penalties in these cases. However, because of the *Zelener* decision and its progeny, the Commission has lost some key forex cases and now finds it is more difficult to prosecute forex actions. Unless Congress clarifies the Commission's jurisdiction over off-exchange forex transactions, a large sector of retail fraud will remain effectively outside of the prosecutorial authority of the CFTC.

In November 2005, the PWG submitted to Congress a narrowly tailored proposal to allow the Commission to prosecute forex fraud cases. The proposal would require those who participate in the solicitation of retail forex transactions to register with the CFTC. It would also close a loophole that allowed firms to notice register as securities broker-dealers and serve as counterparties to off-exchange forex transactions. Last, the proposal would bolster the CFTC's anti-fraud authority over retail off-exchange forex transactions like those in dispute in the *Zelener* case. This narrow fix is endorsed by the PWG and was included in the reauthorization bill that this Committee and the House of Representatives passed in 2005.

Principal-to-Principal Antifraud Authority

The Commission also submits to this Committee that it may wish to address an important issue relating to the CFTC's antifraud authority for futures contracts. Congress should clarify that CEA Section 4b, the CFTC's main antifraud provision, gives the CFTC the authority to bring fraud actions in off-exchange "principal-to-principal" futures transactions. This clarification is necessary to eliminate a potential obstacle to the use of the CFTC's antifraud authority in today's non-intermediated markets.

In late November 2000, the Seventh Circuit Court of Appeals suggested that the CFTC may be able to use Section 4b only in "intermediated" transactions — *i.e.*, those involving a broker-customer relationship. In other words, the court indicated that the CFTC may not be able to use its Section 4b antifraud authority in principal-to-principal transactions. Meanwhile, at about the same time, the CFMA was enacted to permit off-exchange futures transactions entered into on a principal-to-principal basis, such as energy transactions pursuant to CEA Sections 2(h)(1) and 2(h)(3). Congress specifically reserved the CFTC's Section 4b antifraud authority in Section 2(h) of the CEA so that the CFTC could prosecute fraud involving transactions conducted under that Section. Since all Section 2(h) transactions must be done on a principal-to-principal basis to qualify for the exemption, it is important to clarify that the CFTC's Section 4b antifraud authority applies to these non-intermediated transactions. Without this clarification, the work of Congress in 2000 to protect energy markets from fraud could be rendered meaningless.

Accordingly, the House reauthorization bill of 2005 would have amended subsection 4b(a)(2) by adding the words "or with" in order to address off-exchange principal-to-principal transactions. This new language would make it clear that the CFTC has the authority to bring antifraud actions in off-exchange, principal-to-principal futures transactions, including exempt commodity transactions in energy under Section 2(h). This amendment to Section 4b would implement Congressional intent to reserve the CFTC's antifraud authority with regard to these transactions.

I note that the Section 4b language was supported by the Futures Industry Association, the National Futures Association, the Chicago Mercantile Exchange, the Chicago Board of Trade, the NYMEX, USFE, and others during the last attempt at reauthorization.

In addition, the Commission asks Congress to enhance its penalty scheme for market manipulation to reflect the economic severity of such activity as well as the importance of protecting these markets. The Commission recommends amending the CEA to increase the civil and criminal penalties available for certain violations of the CEA such as manipulation, false reporting, and conversion. The maximum fines under Section 9 should be increased to $1 million, and the maximum prison sentence should be increased from five to 10 years. The Commission also recommends certain conforming amendments to the enforcement provisions in Sections 6(c), 6b, and 6c of the CEA to effectuate this increase in civil monetary penalties. Increasing the civil penalties that may be imposed for manipulation to $1 million would conform the CEA to the penalty provisions that Congress enacted in the Energy Policy Act of 2005 for manipulation cases brought by the FERC with respect to the physical energy markets.

Conclusion

The CFTC has been able to work within the current structure of the CEA to oversee futures markets, to ensure the integrity of the price discovery mechanism, to maintain the financial integrity of the markets, and to protect customers. The CFTC stands ready to offer its assistance as Congress moves through the reauthorization process and considers these various options.

As the futures markets have grown in size and complexity, the Commission continues to evolve in the administration of its duties. However, the Commission's funding has remained static over the past few years, while staff levels have decreased to historically low levels. The Commission has always done more with less, but it is currently stretched to the limit. In reauthorization, Congress should be mindful of the resources that are needed to fulfill the Commission's mandate. I am hopeful that Congress will support sufficient funding of the CFTC at a level that matches its regulatory expectations for this agency and the growth of these markets.

My fellow Commissioners and I welcome this opportunity to work with you on the reauthorization of the CFTC. I greatly appreciate the opportunity to testify before you today on this important matter and would be pleased to answer any questions that the Committee may have.