COMMODITY FUTURES TRADING COMMISSION

☆ 1975 ☆

Commissioner Walter Lukken

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Commodity Futures Trading Commission (CFTC)

- Independent government agency created in 1974, similar to the Securities and Exchange Commission
- Oversees U.S. commodity futures and options markets
- Protects participants against manipulation, abusive trade practices and fraud
- Ensures integrity of risk management markets in the U.S.

CFTC Organizational Overview

- Five Commissioners
  - One Chairman, Two Republicans, Two Democrats
  - Appointed by the President, Confirmed by the Senate

- Approximately 500 Employees

- Offices in DC (headquarters), Chicago, New York, Kansas City and Minneapolis

Funding the CFTC

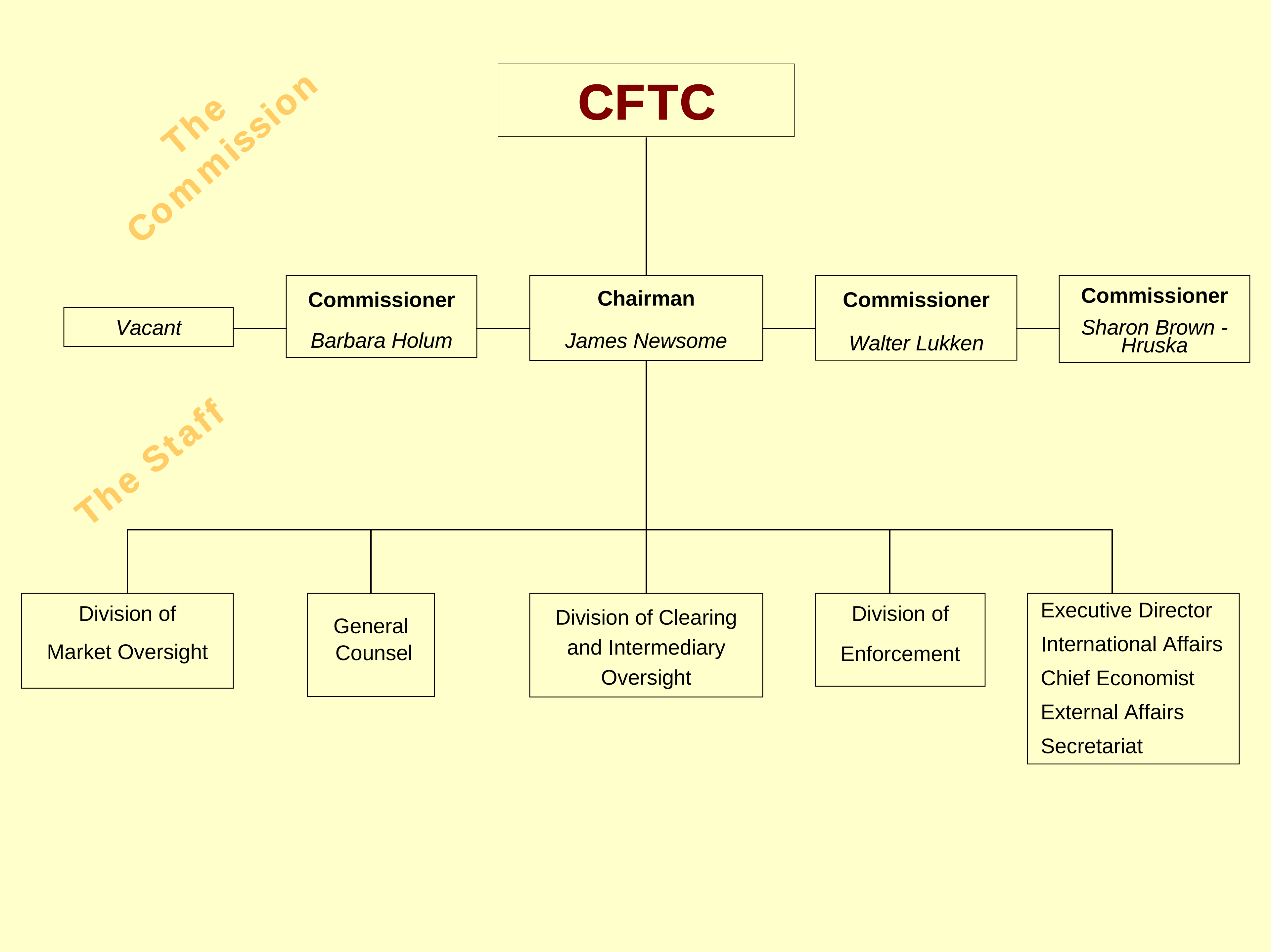
- Annual Agricultural Appropriations Bill
- FY ’03 – $86 million
- No industry transaction fees

Number of Registered Commodities Professionals

Companies and individuals who handle customer funds or give trading advice must apply for registration through the NFA, a self-regulatory organization to which the Commission has delegated that responsibility subject to CFTC oversight. The Commission regulates the activities of nearly 65,000 registrants:

Type of Registered Professional	Number in 2001
Associated Persons (Sales People)	*48,763*
Commodity Pool Operators (CPOs)	*1,761*
Commodity Trading Advisors (CTAs)	*2,749*
Floor Brokers (FBs)	*8,628*
Floor Traders (FTs)	*1,296*
Futures Commission Merchants (FCMs)	*192*
Introducing Brokers (IBs)	*1,603*
TOTAL	*64,992*


House Agriculture Committee
Senate Agriculture Committee
UNITED STATES CAPITOL.
WASHINGTON, D.C.


CFTC
The Commission
Commissioner
Barbara Holum
Chairman
James Newsome
Commissioner
Walter Lukken
Commissioner
Sharon Brown - Hruska
Vacant
The Staff
Division of Market Oversight
General Counsel
Division of Clearing and Intermediary Oversight
Division of Enforcement
Executive Director
International Affairs
Chief Economist
External Affairs
Secretariat

Division of Enforcement (DOE)

- Fraud
- Unlawful Off-Exchange Activity
- Manipulation
- Trade Practice Violations
- Registration Violations

Division of Market Oversight (DMO)

- Market Surveillance
  - Oversee markets using CFTC's large trader reports to ensure that commodities are not being manipulated
  - Provide weekly surveillance briefings to the Commission
- Market and Product Review
  - Review new market and product applications to ensure they comply with the Commodity Exchange Act (CEA)
- Market Compliance
  - Conduct periodic audits to ensure exchanges are complying with the CEA

Division of Clearing and Intermediary Oversight (DCIO)

- Intermediary Policy and Oversight
  - Oversee futures and options market intermediaries (e.g. FCMs, APs) to ensure financial integrity and protection of customer funds
- Clearing Policy and Oversight
  - Oversee clearing houses to ensure financial integrity

Office of the General Counsel

- Appellate Litigation
  - Represent Commission in federal courts
- Regulation
  - Review all proposed and final agency rulemaking
- Legislation
  - Work with the Hill and other regulators on financial market legislative issues

CFTC **Has** Jurisdiction Over the Following Products:

- Financial and agricultural commodity futures contracts
- Financial and agricultural commodity options contracts
- Retail foreign currency futures
- Sole jurisdiction over broad-based security futures indexes
- Joint jurisdiction with SEC on single-stock and narrow-based security futures products

CFTC **Does Not** Have Jurisdiction Over the Following Products:

- Excluded Over-the-Counter (OTC) derivatives
- Forward contracts
- Securities
- Banking products

Overview of the Industry

- The Products
- The Participants
- The Mechanics of Trading

The Products: Futures

A Futures Contract Is: an obligation to buy or sell a given amount of a commodity for delivery in the future at a price determined today.

Long – the buyer (or to buy)

Short – the seller (or to sell)

The Products: Options

An Option Contract Is: a contract which gives the buyer the **right**, but **not** the **obligation**, to buy or sell a commodity (or a futures contract) at a specific price within a specified time.

Put	**Option to Sell**
Call	**Option to Buy**
Buyer	**Pays Premium; Has right to exercise**
Grantor/Seller	**Receives Premium; Has obligation to perform.**
Strike Price	**Price at which the option is exercised.**

The Products: Forwards

A Forward Contract Is: a contract to exchange a commodity at a set price in the future.

	Forwards	**Futures**
Size of Contract:	Negotiable	Standardized
Delivery Date:	Negotiable	Standardized
How Priced:	Private Negotiation	Open Outcry/Pit Traded
Security Deposit:	Depends on Buyer/Seller Relationship	Margin, Set by the Exchange
Frequency of Delivery:	Very High	Very Low
Regulation:	State/Federal Laws of Commerce	Exclusively CFTC
Guarantor:	None Required by Federal Law	Clearing House

The Products: Over-the-Counter (OTC) Derivatives

An OTC Derivative Is: a general term meant to describe individually negotiated contractual agreements that occur off an organized exchange, between sophisticated investors; the contracts shift risk between parties through the transfer of payment streams.

Swaps are a common OTC derivative that transfer risk through the exchange of payment streams (e.g., fixed interest rates for floating interest rates)

The Policy Problem:

How do you tell the difference between a futures, a forward, and an OTC derivative?

- ✓ As these products have matured and innovated, the lines have blurred in determining one from another.
- ✓ In the 1990's, this definitional problem caused legal and regulatory uncertainty in determining when the CFTC has jurisdiction.
- ✓ This was largely addressed by the *Commodity Futures Modernization Act of 2000 (CFMA)* to exclude from CFTC jurisdiction in financial OTC derivative contracts between sophisticated investors.

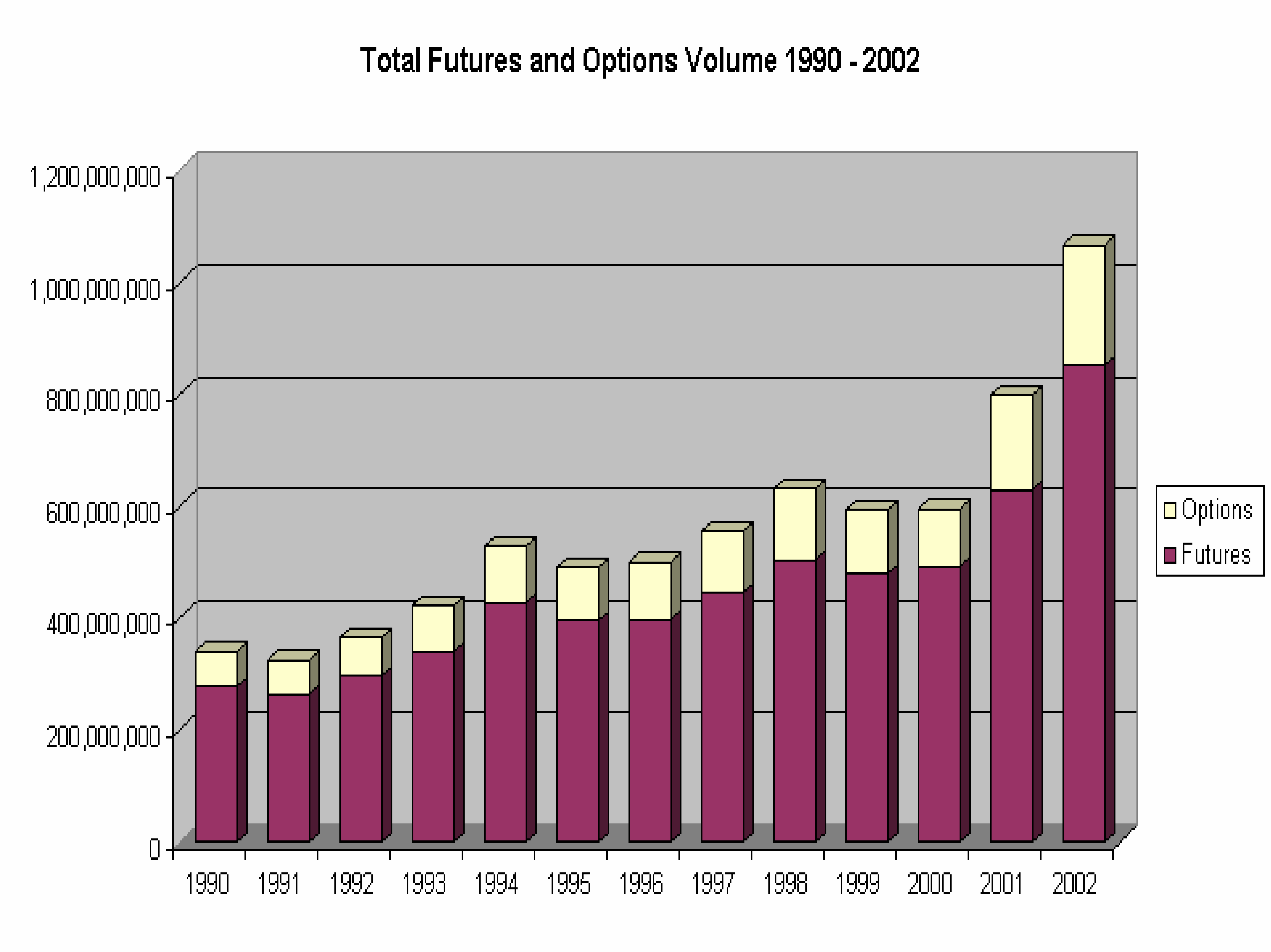
Who are the Players?

The Exchanges

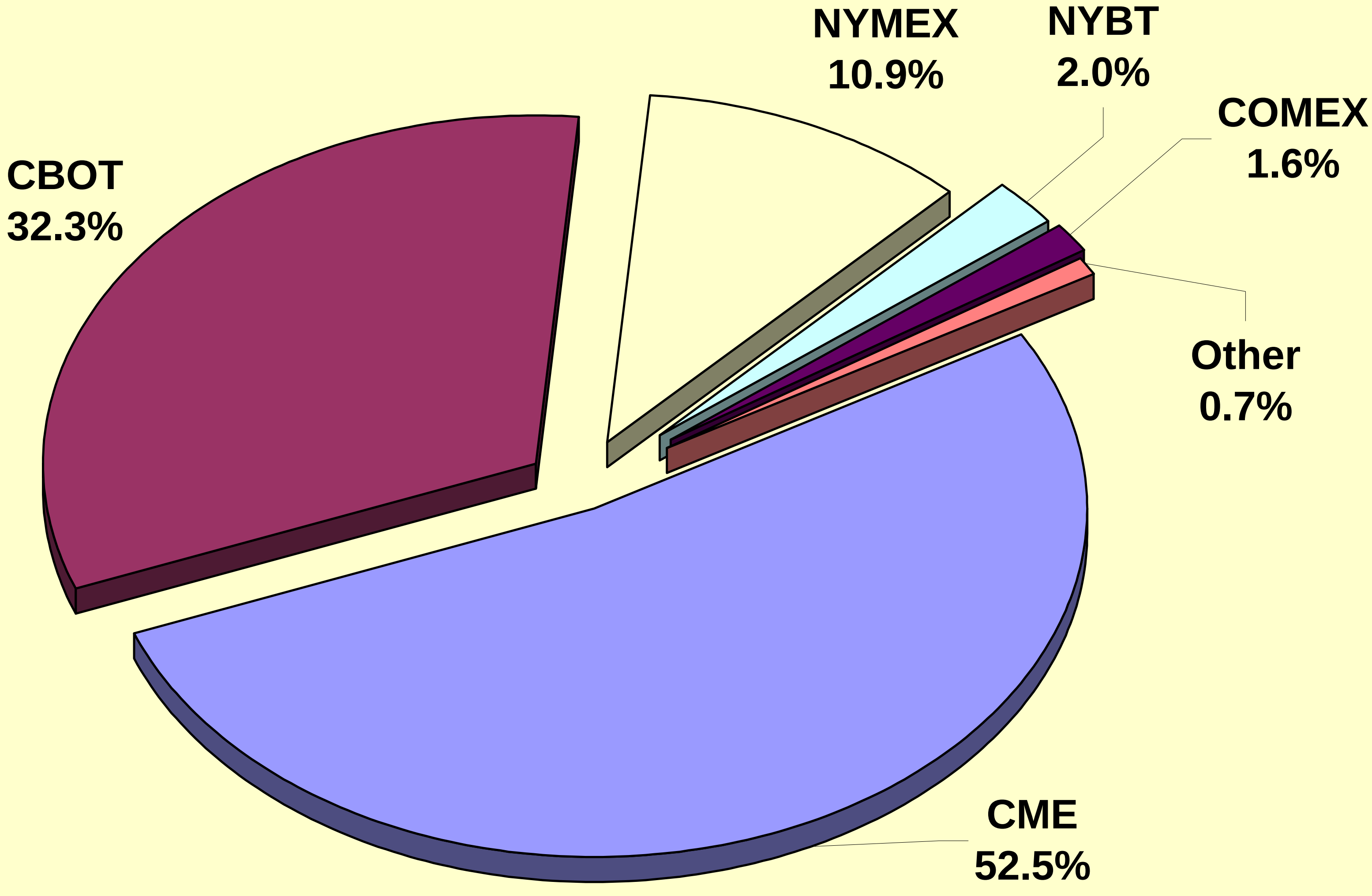
- Exchanges provide a marketplace for matching buyers and sellers
- Exchanges may trade by open outcry (pit trading using hand signals) or electronically
- Serve as a self regulatory organization to ensure compliance with the CEA
- Liquidity is the key to a successful exchange

Exchange Examples

- Chicago Board of Trade (CBOT)
- Chicago Mercantile Exchange (CME)
- New York Mercantile Exchange (NYMEX)
- BrokerTec
- Kansas City Board of Trade (KCBOT)
- Minneapolis Grain Exchange (MGE)
- New York Board of Trade (NYBOT)

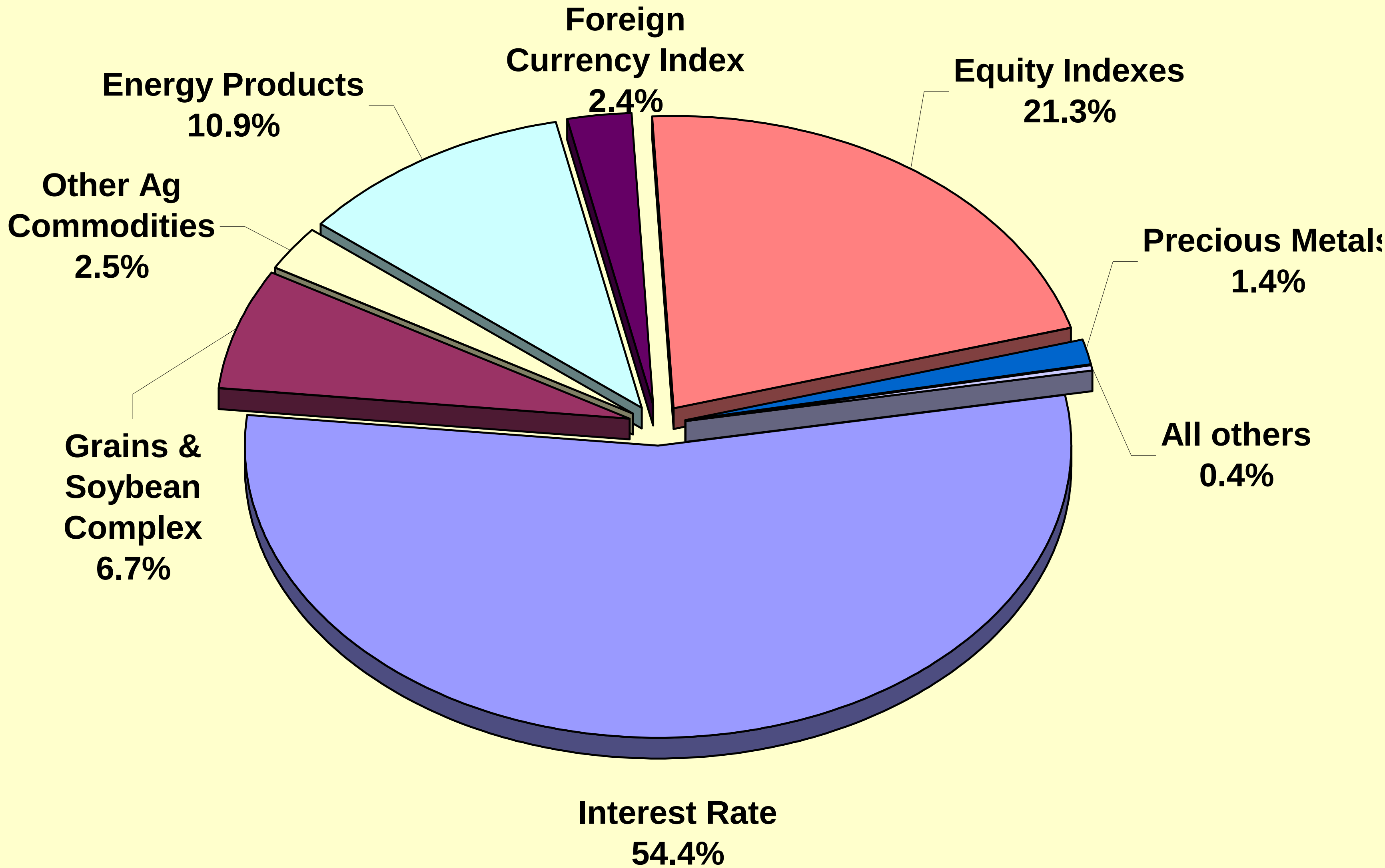

Total Futures and Options Volume 1990 - 2002
1,200,000,000
1,000,000,000
800,000,000
600,000,000
400,000,000
200,000,000
0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
Options
Futures

2002 Total Volume by Exchange



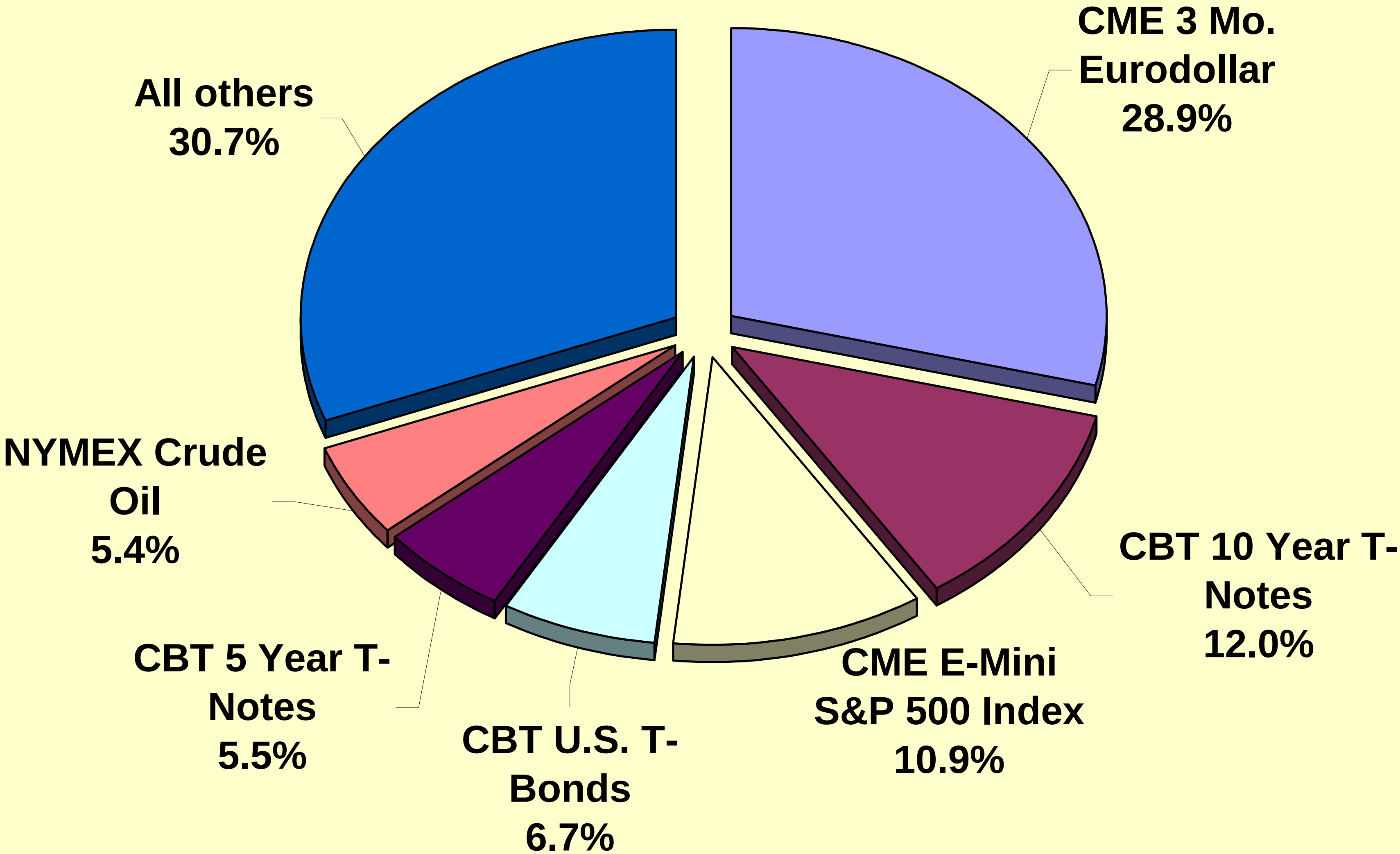
Source: Futures Industry Assoc.

2002 Total Volume by Commodity Group



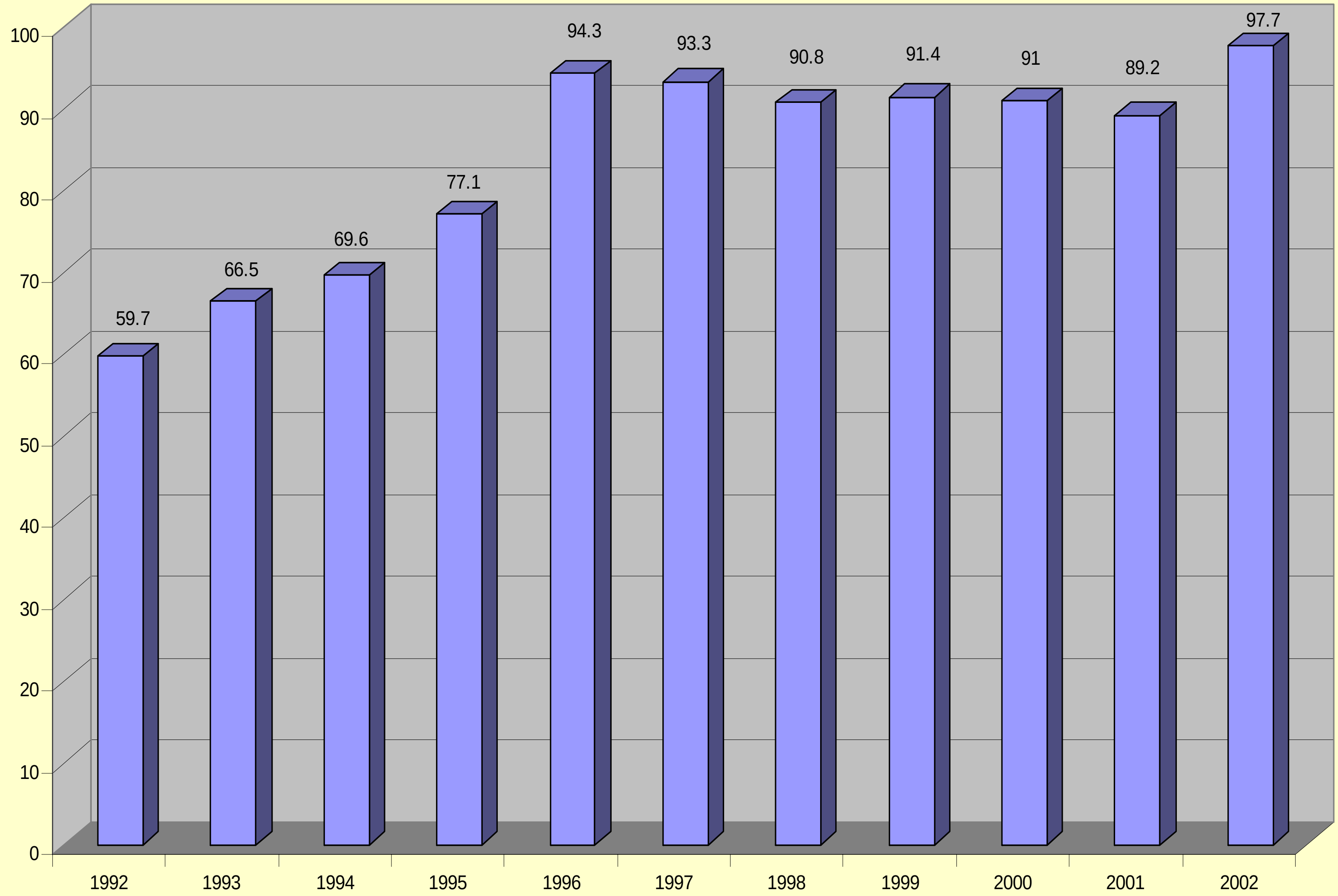
Source: Futures Industry Assoc.

2002 Total Volume by Largest Contracts



Source: Futures Industry Assoc.

Total Volume in Agricultural Futures and Options Markets 1992-2002



Derivatives Clearing Organizations:

- Serve to minimize credit risk by acting as a central counterparty for all trades; backed by large financial firms
- May be a division of the exchange (e.g. CME) or a separate organization (e.g. Board of Trade Clearing Corporation)
- Work with exchanges to enforce margin levels and administer “mark to market” process
- Central counterparty: “Buyer to every Seller—Seller to every Buyer”

Two Types of Traders

- Hedgers
- Speculators

Hedgers

Hedgers are people with a cash market position in a commodity who often decide to protect against adverse price changes through the purchase of an opposite futures position. *Example: Farmers, banks and agribusinesses*

Speculators

Speculators are those individuals who do not have an interest in the underlying commodity but are willing to accept the risk that a hedger is laying off in the marketplace.

Speculators play an important role in the futures markets because there are not always enough hedgers to match a long hedge with a short hedge.

Speculators who desire to take on risk **provide liquidity** so that hedgers can do so more easily.

CFTC Primary Registrants

- Futures Commission Merchants (FCM)
- Introducing Brokers (IB)
- Associated Persons (AP)
- Commodity Pool Operators (CPO)
- Commodity Trading Advisors (CTA)
- Floor Brokers (FB)
- Floor Traders (FT)

Futures and Derivatives Industry Organizations

Major Trade Associations

- Futures Industry Association (FIA)
- Managed Funds Association (MFA)
- National Introducing Brokers Association (NIBA)
- International Swaps & Derivatives Association (ISDA)

Example of a Simple Short Hedge…

Economic Purpose of Futures Contracts

- Hedging: the protection of an existing position in a commodity from adverse price movements.
- Price Basing or Price Discovery: the use of futures prices to determine cash market prices.

Dave, a Corn Farmer and Hedger

Farmer Dave plants corn during the spring and expects a crop of 50,000 bushels.

He decides to hedge against a decline in the price of corn using the CBOT December corn futures (the first new crop month).

Each futures contract is for 5,000 bushels, so he sells 10 contracts.

Farmer Dave Hedges on May 15

The Spot Price (current market price) is $2.20/bushel. At that price, the crop is worth $110,000 (50,000 x 2.20).

Farmer Dave determines that this price is enough to cover the expenses of planting and make a profit.

Farmer Dave sells 10 Dec corn contracts at $2.35/bushel, for a value of $117,500 (50,000 x 2.35). The Dec corn price reflects the expectations for the new crop.

Farmer Dave Unwinds Position on November 15

He sells 50,000 bushels in the spot market for $1.85/bushel ($92,500). This is $17,500 less than the value ($110,000) of the spot position on May 15.

Then Farmer Dave offsets his futures position and buys 10 Dec corn futures contracts for $2.00/bushel ($100,000), $17,500 less than the $2.35/bushel ($117,500) at which he sold the futures in May.

Thus, Farmer Dave has profited on the futures market by $17,500 and lost $17,500 in the cash market.

Summary of Short Hedge

Futures

- On May 15, sell 10 Dec corn futures on May 15 at $2.35/bushel ($117,500)
- On Nov 15, buy 10 Dec corn futures on Nov 15 at $2.00/bushel ($100,000)
- *Gain from Futures position: $17,500*

Spot

- On May 15, the expected 50,000 bushel corn crop is worth $110,000 based on spot price of $2.20/bushel
- On Nov 15, crop is worth $92,500 at $1.85/bushel spot price
- *Loss from cash position: $17,500*

Analysis

In the case of Farmer Dave, the hedge worked perfectly and he locked in his price of $2.20 a bushel.

History of US Agricultural and Financial Futures Trading

Birth of the Futures Exchanges

Chicago Board of Trade - 1900

Birth of the Futures Exchanges

- *1848: Chicago Board of Trade* is formed by local grain merchants to even out price spikes and dips caused by seasonal gluts and shortages in commodities.
- "Spot" trading gradually leads to "forward" contracts, which become standardized as "futures" contracts.
- First futures include wheat, corn and oats, which are still traded to this day.

Birth of the Futures Exchanges

- *1870: New York Cotton Exchange* is established.
- *1877: Kansas City Board of Trade* establishes a futures market for hard red winter wheat grown on Great Plains. A corn contract is added in 1879.
- *1885: Minneapolis Grain Exchange* introduces spring and durum wheat futures to accommodate Northern Plains' producers.
- *1919: Chicago Mercantile Exchange (CME)* is formed out of old Butter & Egg Board.

Federal Regulation of Futures Markets

FDR letter to House Committee on Interstate and Foreign Commerce, March 26, 1934:

"Unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions of the years following 1929."

Federal Regulation of Futures Markets

1936: Congress enacts the *Commodity Exchange Act (CEA)*, creating Commodity Exchange Authority in the U.S. Department of Agriculture (USDA), predecessor to CFTC.

1970’s: The Modern CEA

- *1972: CME* starts trading first financial futures in currencies of the Canadian dollar, Japanese yen, Swiss franc, German deutsche mark, Dutch guilder, Mexican peso and British pound.
- *1974:* To provide CFTC jurisdiction over non-agricultural commodities, Congress passes the modern *CEA*, which expands the definition of commodity futures to include “all services, rights and interests.”
- This broad definition, together with providing the CFTC with exclusive jurisdiction over commodity futures, caused jurisdictional issues among federal regulators and industry participants.

1980's: Jurisdiction Issues

- ***1975: GNMA Contract Designation****:* The *CBT* is designated as a contract market in Government National Mortgage Association Certificates (GNMAs), the first interest rate futures contract. Disputes over jurisdiction with SEC were eventually resolved by 7th Circuit (Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137 (7th Cir 1982)), which confirmed CFTC's exclusive jurisdiction over Ginnie Mae options.
- ***Dec 7, 1981:* Shad/Johnson Accord**

  The CFTC and the SEC jointly announce a basic jurisdiction agreement on the regulatory responsibility of each agency for a variety of financial instruments.

1980's: Jurisdiction Issues

Shad /Johnson Accord

- ❖ Required that stock index futures be cash settled
- ❖ Required that the index be broad-based and not readily susceptible to manipulation
- ❖ Required that the index reflect a substantial segment of the market is aims to measure
- ❖ The CFTC and SEC reviewed all domestic stock index designations and foreign stock index no-action requests to make sure the above criteria were met
- ❖ Banned narrow-based and single-stock security futures products.

1980's: Jurisdiction Issues

- *1983:* The CFTC designates the first contract markets for options on stock index futures contracts. The markets include options on the NYSE Composite futures, traded on the *NYFE (NYBOT);* and the S&P 500 futures, traded on the *CME*.
- *1988:* The CFTC designates the first futures contract markets on foreign stock indices and foreign government debt instruments.

1990's: Clarification of CFTC Oversight

- 1992-- Congress passes the Futures Trading Practices Act, which provides the CFTC with authority to exempt products out of its jurisdiction.
- Congress directs the CFTC to exempt swaps, hybrids and energy derivatives from its jurisdiction, which it does.

1990's: Clarification of CFTC Oversight

- After a May 1998 CFTC Concept Release that further clouded the issue of whether the CFTC had jurisdiction over OTC derivatives, the SEC, Federal Reserve and Treasury Department ask Congress to place a regulatory moratorium on the CFTC until a study on OTC derivatives can be conducted by these regulators.
- Congress imposes the moratorium, allowing for the completion of the President's Working Group study.

President's Working Group (PWG) Report on OTC Derivatives, Nov. 1999:

- There is a strong public policy to provide legal certainty to the OTC derivatives market by excluding financial OTC products between sophisticated investors from the CFTC's jurisdiction.
- There is a public interest to provide regulatory reform for the futures markets and its participants.
- Lifting the ban on single- and narrow-based security futures products is attainable if a joint regulatory structure between the SEC and CFTC is provided.

2000 and Beyond: CFMA

The Commodity Futures Modernization Act of 2000 (CFMA) was signed into law by President Clinton on *December 21, 2000.*

- The CFMA was the most significant piece of legislation affecting the derivatives and futures markets in 25 years.

- The legislation was based primarily on the 1999 report of the PWG on financial markets.

Three Legs of the CFMA

I. **Legal Certainty -** Exclude from CFTC's jurisdiction if:

- Product being traded is not readily susceptible to manipulation (financial products)
- Entity or person trading the product is a large, sophisticated customer
- Generally, institutional customers are otherwise regulated by other government agencies (banks, insurance companies)

Three Legs of the CFMA

II. Regulatory Reform for the Exchanges

- Created tiered regulatory structure for exchanges based on the types of products being traded and the sophistication level of the individuals doing the trading
- Shifted from prescriptive regulatory regime to Core Principles

Three Legs of the CFMA

III. Security Futures Products (SFPs):

- Lifted the Shad-Johnson Ban on single-stock futures.
- Provided outline for CFTC and SEC to jointly regulate these products.
- In Nov. 2002, OneChicago and NQLX began to trade security futures products in the U.S.

2000 and Beyond: Potential Policy Issues Ahead

- OTC Energy Trading - Is more oversight needed?
- Security Futures Products
- Clearing Choice
- Greater Global Competition
- Exchange Governance and Self Regulation

Commissioner Walter Lukken