Mr. Chairman and members of the Committee, my name is Jim Newsome and I am the President of the New York Mercantile Exchange (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. We are a federally chartered marketplace, fully regulated by the CFTC. On behalf of the Exchange, its Board of Directors and members, I thank you and the members of the Committee for the opportunity to participate in today's hearing on the reauthorization of the CFTC.

The Commodity Exchange Act (CEA) as amended by the Commodity Futures Modernization Act of 2000 (CFMA or the Act) was truly a landmark piece of federal legislation that has provided critically needed legal certainty and regulatory streamlining and modernization to U.S. futures and derivatives markets. The legislative history preceding the passage of the CFMA was a long one that involved a lot of hard work and give and take on all sides. We commend this Committee for all of its efforts in achieving the passage of the final bill.

It is the view of NYMEX that the CEA, as amended by the CFMA, is by all indicators, providing a reasonable, workable, and effective oversight regime for the regulated exchanges.

The CFMA is providing a well-considered oversight framework that has enhanced the abilities of NYMEX and the other regulated exchanges to operate in a rapidly changing business environment and that has provided competitive benefits to the marketplace while continuing to ensure confidence in the integrity of our markets.
Prior to the CFMA, the CFTC operated under a "one size fits all" regulatory approach. Regulatory inequities imposed severe and unreasonable constraints on domestic exchanges competing with international and with unregulated exchanges operating in this country. In particular, prior approval requirements for rule and contract changes, especially where few or no substantive regulatory concerns were present, further exacerbated an uneven playing field and disadvantaged U.S. regulated markets.

The Committee and the Congress agreed that the orientation of the CFTC needed to be shifted to a more flexible oversight role. To address these issues, Congress established various market tiers so that a marketplace could now, in effect, select its appropriate level of regulation according to the product types offered, and more importantly, the participants eligible to trade on the facility.

As a result of the CFMA, NYMEX operates by choice at the highest level of regulation by CFTC under two regulatory categories for its distinct operations as a derivatives clearing organization (DCO) and as a designated contract market (DCM). NYMEX offers both open outcry and electronic trading forums pursuant to the DCM regulatory tier. CFTC staff periodically undertakes reviews to assess the adequacy of self-regulatory programs and

NYMEX has consistently been deemed by these staff reviews to have maintained adequate regulatory programs and oversight to comply with its obligations as a self-regulatory organization (SRO) under the CEA.

In addition to the creation of various new market tiers, Congress largely replaced extremely detailed, prescriptive regulation with more broadly worded "Core Principles" for regulated markets. The regulatory philosophy underpinning the use of these Core Principles is that Congress sets broad performance standards that must be met by the regulated entity, but then the entity will have flexibility with regard to how it complies with these standards.

The CFMA also made clear that regulated DCMs shall have reasonable discretion as to the manner in which they comply with the applicable Core Principles set forth in regulation. The Exchange's ability to respond to rapidly changing markets as needed by introducing market-oriented changes to contracts has broadly benefited market participants, by virtue of new risk management contracts offered to customers. Market participants have also benefited from recent levels of volume by all exchanges. As a result of Congress' foresight and innovation, such improvements can be implemented, subject to CFTC review and oversight, without protracted approval processes.
It is important to point out that, contrary to what some have suggested, the CFMA did not diminish the regulatory oversight responsibilities of the CFTC. Although regulated exchanges may self-certify new contracts and rule changes, CFTC retains the responsibility to assure that all changes are in accordance the guidelines of the Act. In practice, there is always prior discussion with the regulator of any substantive change.

As contrasted with the rule submission process formerly in place, under the CFMA the regulated market can choose whether to self-certify to the CFTC that the rule change or new product complies with CEA and with CFTC regulations, or to request prior CFTC approval on a voluntary basis, or indeed to take both steps. We have utilized all three approaches. On a number of routine rule changes we have submitted self-certification filings. On some more novel changes we have voluntarily requested CFTC approval, and on a few occasions we have certified a rule change but also requested CFTC approval on a post-implementation basis.

While the broader marketplace may now understand that prior approval is no longer formally required by the CEA for exchange rule changes, what may be less understood is the extent to which NYMEX staff continues to consult with the relevant industry before proposing changes to our core products. We maintain a fairly extensive scheme of product advisory committees that generally include representation from all relevant sectors of the applicable energy or metals market. We have maintained these industry advisory committees for a number of years and we rely heavily on their informed views to assist us in weighing the merits of possible changes.

In addition, just as was the case in the pre-CFMA regulatory environment, NYMEX staff also continues to consult regularly with CFTC staff before formally submitting filings on significant rule changes. Depending on the nature of those consultations we may also submit rules informally in draft form even where we will eventually be filing the rule changes with the CFTC through the use of the self-certification process. These discussions regarding proposed rule changes are one example of our broader commitment to maintaining strong lines of communication with our regulator.

Regulatory flexibility not only allows the regulated exchanges to remain competitive, but also produces better services and choices for the broad range of market participants seeking to reduce their exposure to risk.

Exchanges are meeting customer and industry demands more efficiently than ever using the ability to submit new products and rules to the CFTC on a self-certification basis, while adhering strictly to prescribed Core Principles. Innovation and fair competition are made possible by a business and operational model that is flexible and can adapt quickly to change.

Streamlining the product submission process has benefited our market users greatly by allowing NYMEX to bring new products to market and respond expeditiously to customers' market needs. Product innovations such as new platforms for trading and clearing futures have resulted from an enhanced ability to respond to constantly changing industry demands. This means that legitimate market participants benefit from more useful risk management tools, better use of technology, greater liquidity, more efficient pricing, and enhanced customer service. Regulatory flexibility for trading facilities has benefited all market participants by providing more alternatives in platforms, products and business models.

Although NYMEX is essentially a marketplace for commercial participants to hedge risk and discover prices on large volume transactions, the benefits to the marketplace also accrue more broadly to consumers who receive prices based on open and fair competition. The visible and highly competitive daily transactions in energy futures and options on the Exchange provide a true world reference price for the futures commodities traded, that is seen as a reliable global benchmark for energy pricing and that is vital to our economy.

NYMEX customers are largely market participants who prefer to conduct business in a fully and well-regulated marketplace where rules are applied consistently and where prices are transparent and openly disseminated. NYMEX operates under the CFMA's highest regulatory tier, where regulations are designed to safeguard market integrity and allow innovative competition as the driving market force.

Regulatory flexibility was critical in preventing additional corporate meltdowns in the credit risk crisis that followed the collapse of Enron, by enabling the Exchange to respond to the new risk management needs of the energy sector.

The failure of Enron set in motion a disruptive series of events throughout the merchant energy sector. The bankruptcy of such a large market participant raised valid concerns as to the financial strength of other energy firms and counterparty credit risk. In the aftermath of Enron's financial meltdown, other energy trading companies lost credit ratings, stock prices plummeted, and liquidity crises began to develop in these markets because parties lacked confidence in each other's abilities to perform transactions. Firms faced an urgent need for new mechanisms to address these credit issues.

NYMEX Compliance Staff, using established tools such as large trader reporting, position limits, and position reporting, alerted the Exchange to potential problems. Exercising its regulatory flexibility, the Exchange was able to address these issues by rapidly implementing a number of important measures, including the use of EFS (Exchange of Futures for Swaps) and EOO (Exchange of OTC Option for NYMEX Options), both of which are instruments to migrate positions from the over-the-counter (OTC) marketplace to NYMEX and to the protections provided by its clearinghouse.

NYMEX also launched over time an expanding slate of products appealing to OTC participants, which are executed off the Exchange, but brought to the NYMEX clearing mechanism. In so doing, 130 products that are traditionally traded OTC have been brought under the umbrella of a regulated exchange, which establishes the identity of participants, a transaction audit trail, daily position surveillance, and credit security.

Indeed, as the changes were enacted, a substantial number of market participants chose to transfer positions to NYMEX where their risk was mitigated by the protections offered by a federally regulated clearinghouse at which transparency, liquidity, and market oversight are paramount. In the early stages of Enron's difficulties in the fall of 2001, some observers feared that Enron's substantial position in the unregulated OTC marketplace could pose serious problems for a significant number of OTC market participants. In responding to the Enron financial crisis, CFTC utilized its flexible regulatory authority as intended in the statute to approve valuable service innovations while taking prudent steps to maximize systemic integrity. Upheavals in the energy sector following the collapse of Enron and revelations about illegitimate trades executed on less regulated markets serve to underscore the importance of market transparency and a sensible approach to regulation.

The ability of DCOs to clear off-exchange transactions under the CFMA enabled NYMEX to initiate a new clearing service in May 2002. This service allows eligible contract participants to submit transactions in specified products to NYMEX for clearing. In this process as currently implemented at NYMEX, the off-Exchange contracts of market participants are replaced by futures positions to be maintained at the clearinghouse by their carrying Clearing Members, and are thus subject to the same protections afforded other futures contracts. NYMEX's demonstrated success in providing a reliable marketplace and credit security in a time of industry crisis underscores the advantages of doing business on a regulated marketplace to any business entity with credit or price exposure in these markets.

NYMEX's various regulatory safeguards allowed the Exchange to maintain solid footing during this challenging time. NYMEX not only operated safely during a volatile period, but thanks to the flexibility permitted under the CFMA, NYMEX was able to adapt its services expeditiously to provide this displaced market segment with the necessary tools to stabilize impacted businesses, mitigating and perhaps preventing additional credit disruptions.
Market integrity continues to be effectively safeguarded on the regulated exchanges through stringent adherence to the Core Principles set forth in the CFMA. In addition, NYMEX operations remain fully regulated and subject to review by the CFTC at every level.

Both NYMEX and CFTC have numerous enforcement tools at their disposal for use in overseeing markets and ensuring that trading conducted in a fair and orderly manner. As an SRO, NYMEX devotes significant resources to the oversight of all its markets as required by the CEA. As noted previously, CFTC staff routinely conducts rule enforcement reviews of our regulatory programs, the results of which are a matter of public record and are available on the CFTC's Web site. Our business model demands that the financial integrity of the marketplace take precedence over other business priorities. Layers of safeguards are imposed by the Exchange, and overseen daily by the CFTC, under our responsibilities as an SRO.
Our Compliance Department on a daily basis utilizes market oversight tools that include the following:

I) Large Trader Reporting

At the end of each trading day, NYMEX electronically collects from its clearing members and carrying brokers the identities of all participants who maintain open positions that exceed set reporting levels. This information is gathered and aggregated for all reportable participants in order to detect and identify market make-up and concentrations, to ensure compliance with expiration position limits and position accountability levels, and to administer hedge or swap exemptions.

II) Trade Register/Streetbook

NYMEX maintains a detailed and comprehensive audit trail of all transactions executed and cleared in its markets (both open outcry and electronic). Relevant data, such as trade time, executing broker or electronic trader, customer type indicator code and the account number for the beneficial owner of the trade are collected for every executed trade in our markets. The transaction data can be reviewed by the Compliance Department with consideration for any criteria necessary.

NYMEX Compliance Staff routinely reviews trading activity on the Exchange's markets, with a general focus on ensuring compliance with intra-day expiration limits and hedge/swap exemptions, as well as activity during price moves in the market. To accomplish this, Compliance Staff use the Price Change Register to identify volatile periods in a given trading session and then analyze the activity within the Trade Register/Streetbook. Advanced electronic surveillance and analysis are used to identify activity that could indicate potentially disruptive trading by floor members, or by their ultimate customers. If specially trained Compliance Staff identify anomalies, a formal investigation is pursued and, if appropriate, formal disciplinary action will follow.

As an example, NYMEX Compliance Staff utilized these tools in December 2003 to conduct an in-depth examination of Natural Gas trading, and shared its findings with the CFTC. NYMEX did not find any coordinated or otherwise violative activity by any participants in our markets. I should note this market review included a focus on hedge funds, which have been a point of inquiry among members of this Committee. Similarly, the CFTC subsequently publicly released findings that no manipulation occurred in the NYMEX Natural Gas Futures contract.

We recently completed an analysis of hedge fund participation in several NYMEX markets during 2004, which is being submitted to the Committee for the record. NYMEX research suggests that hedge funds serve an overall constructive role in the futures markets. While their participation has not made up a large proportion of our markets to date, we continue to monitor it closely.
At NYMEX, the clearinghouse is operated as another department of the Exchange, also fully regulated by the CFTC. NYMEX's clearinghouse function provides a financial guaranty for all transactions executed on the Exchange, and also for transactions executed off-Exchange but accepted by a NYMEX clearing member firm for clearing through the clearinghouse. The clearing function protects market participants against counterparty credit risk - the risk that either party to a transaction (buyer or seller) could fail to pay such funds due to his or her counterpart as a result of the trade.

Through a system of cross-guarantees among the brokerage firms and banks that comprise NYMEX's clearinghouse, credit risk is mitigated for each participant, because financial performance is generally guaranteed by the clearing member and backed by the Exchange. Customer funds are held by the Exchange and its clearing members in trust accounts, which are segregated from the exposure and funds of the clearing firm or the Exchange itself. NYMEX specializes in the particular risks associated with metals and energy products. We have developed a fair amount of expertise over the years in monitoring these kinds of markets, and our internal risk management procedures involve strict oversight to regularly evaluate risk.
The Exchange is pleased to have obtained a long-term AA+ credit rating from Standard & Poors, largely in recognition of our comprehensive regulatory procedures and thorough market oversight.

The business of the Exchange is clearly contingent on our ability to ensure the integrity of our markets, and on the confidence of our customers and the broader marketplace in our commitment to doing so. In the wake of the collapse of Enron and revelations about unethical trading activity by some market players, transparency and the ability to guarantee market integrity are indeed among the most critical priorities at NYMEX.

The CFMA revisions of 2000 are working as intended.
In closing, it is my view that the regulated futures industry is more robust and competitive as a result of these common-sense revisions to the CEA made by Congress in 2000. The CFMA regulatory scheme is providing an orderly and secure framework for competitive risk management, most notably through a period of major upheavals in the energy sector. In short, the landmark legislative revisions are working as they were intended and no adverse consequences in our markets have resulted from their implementation. I am extremely confident in the ability of current self-regulatory programs at regulated markets to maintain orderly, transparent markets and afford appropriate customer protection.

Finally, although the CFMA ultimately came about because of a strong consensus among a number of key industry constituencies, it is worth noting that the final bill nonetheless included a good number of delicate compromises. Consequently, changes in one area affect and thus could necessitate changes to many other aspects of the regulation.

NYMEX believes that the CFTC followed closely the intent of Congress when implementing the CFMA and that the industry has flourished the way both the Congress and the marketplace envisioned.

Mr. Chairman and Members of the Committee, NYMEX thanks you for your consideration and pledges its full support to work with you and your staff in this reauthorization process and to address constructively any issues that may be of concern to you or that might otherwise arise in this process. Thank you very much.