

Thank you Chairman Cochran, Ranking Member Harkin, and Members of the Committee for the opportunity to testify before you today on behalf of the Commodity Futures Trading Commission ("CFTC" or "Commission"). Before I get started, I would like to acknowledge my colleagues, Commissioners Walt Lukken and Sharon Brown-Hruska, and thank them for their continued support, leadership and hard work, as well as Barbara Holum, who retired from the CFTC last year after serving ten dedicated years as a Commissioner.

The purpose of this hearing is to update you on regulatory issues before the Commission. But, as background, I would first like to describe how the Commission operates. And to put things into context, I would like to provide you with an overview of our progress in implementing the Commodity Futures Modernization Act of 2000 ("CFMA"), which significantly amended the Commodity Exchange Act ("CEA"), and describe how the markets have evolved in response to that landmark legislation.

Background

Congress created the Commission in 1974 to oversee the nation's commodity futures markets. The Commission's mission is twofold: to foster transparent, competitive, and financially sound markets that operate free from manipulation or distortion, and to protect users of those markets from fraud and other abusive practices. Integral to accomplishing its mission are the Commission's two regulatory units devoted to overseeing the day-to-day operations of the markets: (1) the Division of Market Oversight ("DMO"), which is comprised primarily of economists and attorneys who conduct ongoing market surveillance to detect and prevent price distortion and manipulation, process applications from new exchanges, review new contracts and exchange rules for compliance with the CEA, conduct periodic reviews to assess the effectiveness of exchange compliance programs, and monitor the markets for possible trading abuses; and (2) the Division of Clearing and Intermediary Oversight ("DCIO"), which employs auditors, attorneys, and other staff who monitor the financial and operational integrity of clearinghouses and intermediaries to ensure that customer funds are protected and that safeguards are in place to prevent the financial problems of a single entity from posing systemic risk. Also crucial is the Commission's Division of Enforcement ("Enforcement"), which investigates potential violations of the CEA and prosecutes them when they are found.

Historically, futures contracts were traded primarily on agricultural commodities. These contracts gave farmers, ranchers, distributors, and users of everything from corn to cattle an efficient and effective set of tools to handle the price volatility often experienced in agricultural markets. As time passed, however, the risk management benefits of the futures markets became apparent to other sectors of the economy, and exchanges sought to apply the mechanics of

futures trading to new products, such as currencies, sovereign debt, metals, and energy. Manufacturers now use futures contracts to fix their raw material costs and reduce uncertainty over the prices they receive for finished products sold overseas. Mutual fund managers can now use stock index futures to protect against market volatility and to effectively put a floor on portfolio losses, and electric power generators can use futures contracts to secure stable pricing for their coal and natural gas needs. Today, while agricultural contracts are traded as actively as ever and continue to grow in volume (the Chicago Board of Trade reported record numbers in its agricultural futures and options complex for the month of April, up 53.6 percent over last April), the vast majority of trading is in financial products. Our most recent statistics show that approximately 9% of futures and options trading is in the agricultural sector, while 54% is in interest rate products such as three-month Eurodollars and ten-year U.S. Treasury Notes, 24% is in equity index products, for example, the S&P 500, 9% is in the energy sector, such as crude oil and natural gas, 3% is in currencies, and 2% is in metals.

Although I have described the primary purpose of the futures markets as a mechanism for risk management, many futures markets play another important role in the economy--that of price discovery. Businesses and investors that may not be direct participants in a particular futures market may nonetheless refer to the quoted prices of certain futures market transactions as reference points or benchmarks for other types of transactions and decisions. This is particularly important in many agricultural markets where no other means of price discovery exist outside the quoted futures prices, but it is also true in other sectors, including many energy markets.

How the CFTC Performs Its Mission

In seeking to fulfill its mission, the Commission focuses on issues of integrity. We seek to protect the economic integrity of the futures markets so that they may operate free from manipulation or congestion (for example, an artificial price situation not intentionally caused by market participants). We seek to protect the financial integrity of the futures markets so that the insolvency of a single market participant does not become a systemic problem affecting other market participants or financial institutions. We seek to protect the operational integrity of the futures markets so that transactions are executed fairly, proper disclosures are made to customers, and fraudulent sales practices are not tolerated. The Commission pursues these goals through a multi-pronged approach to market oversight.

Economic Integrity

The Commission protects against manipulation and congestion by working with exchanges and

potential exchanges through reviewing exchange rules and proposed rule changes prior to trading, and applications for designation. Once trading begins in a new or revised contract, the Commission acts through direct market surveillance and by overseeing the surveillance efforts of the exchanges themselves. The heart of the Commission's direct market surveillance program is the large-trader reporting system, under which clearing members of exchanges, futures commission merchants ("FCMs"), and foreign brokers electronically file daily reports with the Commission. These reports show all trader positions above specific reporting levels set by CFTC regulations. Because a trader may carry futures positions through more than one FCM, and because a customer may control more than one account, the Commission routinely collects information that enables its surveillance staff to aggregate information across FCMs and for related accounts.

Using these reports, the Commission's surveillance staff closely monitors the futures and option market activity of all traders whose positions are large enough to potentially effect the orderly operation of a market. For contracts that are settled through physical delivery at expiration--such as energy contracts--staff carefully analyzes the adequacy of potential deliverable supply. In addition, staff monitors futures and cash markets for unusual movements in price relationships, such as cash/futures basis relationships and inter-temporal futures spread relationships, which often provide early indications of potential problems.

The Commissioners and senior staff are kept apprised of market events and potential problems at weekly surveillance meetings and more frequently when needed. At these meetings, surveillance staff briefs the Commission on broad economic and financial developments and on specific market developments in futures and option markets of particular concern.

If indications of attempted manipulation are found, the Commission's Enforcement staff investigates and prosecutes alleged violations of the CEA or Commission regulations. The Commission has available to it a variety of administrative sanctions against wrongdoers, including revocation or suspension of registration, prohibitions on futures trading, cease and desist orders, civil monetary penalties, and restitution orders. The Commission may seek federal court injunctions, restraining orders, asset freezes, receiver appointments, and disgorgement orders. If evidence of criminal activity is found, the Commission may refer matters to state authorities or the Justice Department for prosecution of violations. Those authorities may bring cases under the CEA, or under state or federal criminal statutes such as those prohibiting mail fraud, wire fraud, and conspiracy. Over the years, the Commission has brought numerous enforcement actions and has imposed sanctions against firms and individual traders for manipulating or attempting to manipulate prices, including the well-publicized cases

against Sumitomo for alleged manipulation of copper prices and against the Hunt brothers for manipulation of the silver markets. Over the past year-and-a-half, the Commission has filed 16 enforcement actions against 20 major energy companies and two individuals resulting from our investigations in the energy sector, and has collected almost \$200 million in civil monetary penalties to date.

Financial Integrity

In protecting the financial integrity of the futures markets, the Commission's two main priorities are to avoid disruptions to the system for clearing and settling contract obligations, and to protect the funds that customers entrust to FCMs. Clearinghouses and FCMs are the backbone of the exchange system. Together, they work to prevent the financial difficulties of one trader from becoming a systemic problem to other traders. Several aspects of the financial integrity framework help the Commission to achieve these goals with respect to traders: (1) requiring that market participants post margin to secure their ability to fulfill obligations; (2) requiring participants on the losing side of trades to meet their obligations, in cash, through daily (sometimes intraday) margin calls; and (3) requiring FCMs to segregate customer funds from their own funds.

The Commission also works with the exchanges and the National Futures Association ("NFA") to closely monitor the financial condition of the FCMs themselves, which must provide the Commission, exchanges, and the NFA with various monthly, quarterly, and annual financial reports. The exchanges and the NFA also conduct periodic audits and daily financial surveillance of their respective member FCMs. Part of this financial surveillance involves looking at each FCM's exposure to losses from the large customer positions they carry. As an oversight regulator, the Commission reviews the audit and financial surveillance work of the exchanges and the NFA, but also monitors the health of FCMs directly, as appropriate. The Commission also periodically reviews clearinghouse procedures for monitoring risks and protecting customer funds.

As with attempts at manipulation, the Commission's enforcement staff investigates and prosecutes FCMs alleged to have violated financial and capitalization requirements or to have committed other supervisory or compliance failures in connection with the handling of customer business. Such cases can result in substantial remedial changes in the supervisory structures and systems of FCMs and can influence the way particular firms conduct business. This is an important part of fulfilling the Commission's responsibility for ensuring that sound practices are followed by FCMs.

Operational Integrity

Protecting the operational integrity of the futures markets is also accomplished through the requirements that mandate appropriate disclosure and customer account reporting, as well as fair sales and trading practices by registrants. Commission oversight helps to maintain appropriate sales practices by requiring fitness screening of industry professionals, proficiency testing, continuing education, and supervision of these persons. Extensive recordkeeping of all futures transactions is also required. Commission staff reviews compliance with those requirements and other requirements. Finally, the Commission oversees the self-regulatory programs of the exchanges and the NFA through regular reviews.

As with the Commission's efforts to protect the economic and financial integrity of the futures markets, the Commission's Enforcement staff also plays an important role in deterring behavior that could compromise the operational integrity of the markets by investigating a variety of trade and sales practice abuses that affect customers. For example, the Commission brings actions alleging unlawful trade allocations, trading ahead of customer orders, misappropriating customer funds, and non-competitive trading. The Commission also takes action against unscrupulous commodity professionals who engage in a wide variety of fraudulent sales practices against the public.

Changes in the Futures Markets, Pre and Post-CFMA

Many changes have occurred in the futures markets over the last twenty-five years. As I mentioned earlier, when the CFTC was founded the vast majority of futures trading was based on agricultural commodities, but evolved over time to include a wide variety of products, with financial products predominating today. As these developments occurred, the locations, hours and methods of futures trading also expanded. In the early days of the Commission, trading was largely confined to the U.S. and was done by open outcry during limited daytime hours in exchange trading pits designated by the CFTC as contract markets. Today, trading occurs on traditional exchanges by open outcry and electronically, at new, all-electronic exchanges, and off-exchange entirely. The markets have also become global in nature, with large numbers of foreign traders participating in U.S. markets and vice versa, and with linkages between U.S. exchanges and foreign counterparts operating around the clock.

In recognition of the growing importance of the futures markets to the domestic and global economies, and the need to lift restraints on the ability of exchanges to keep pace with rapidly

developing technological advances and to respond quickly to demands for new products, in 2000, under the leadership of this Committee, Congress rejected the one-size-fits-all approach to regulation by passing the CFMA. The CFMA amended the CEA to establish a structure in which markets can choose to operate under varying levels of Commission oversight, depending on the products traded, the type of system in which they are traded, and the sophistication of the market participants. Under this new regulatory framework, exchanges are subject to broad core principles governing operational integrity rather than prescriptive rules. In addition, Congress:

? granted exchanges the ability to list new products and amend contract rules by certifying that they comply with the CEA, rather than having to seek the prior approval of the Commission;

? unbundled the clearing function from the trade execution function and granted the Commission explicit authority over derivatives clearing organizations ("DCOs"), which were authorized to clear both on-exchange and over-the-counter ("OTC") transactions;

? provided legal certainty for OTC transactions;

? legalized security futures products ("SFPs"); and

? clarified the CFTC's jurisdiction over retail foreign currency trading.

Over the approximately three-and-a-half years since the CFMA was signed into law, the Commission has concentrated its efforts on redesigning its regulatory programs to achieve the objectives of the statute. Our first task was to modernize the rules regarding trading facilities, both traditional and the new exempt commercial markets and exempt boards of trade permitted by the CFMA, and to establish guidance for new applicants and existing exchanges on how to comply with the core principles. We also studied, through hearings, roundtables, and the solicitation of public comment, our regulations relating to FCMs, commodity pool operators ("CPOs") and other futures market intermediaries, to identify areas where improvements could be made and where matters could be delegated to the NFA. We devoted much of last year implementing a number of modernizations in this area ranging from registration relief for operators of certain pooled investment vehicles that restrict participation to sufficiently well sophisticated persons, to affording FCMs greater operational flexibility so that they can provide their customers with more efficient trade executions.

In both of these endeavors the Commission's goal was to streamline and eliminate regulations where appropriate, while keeping important market integrity and customer protections in place. It was hoped that these reforms would, among other things, encourage innovation by existing exchanges and market participants and lower the regulatory costs for new entry into the markets, which in turn would result in a heightened level of competition that would benefit the

marketplace as a whole. The indications thus far are that this is exactly what has happened.

Some numbers will illustrate my point. In the few, short years since passage of the CFMA, the Commission has approved eight new exchanges as designated contract markets and has accepted the registrations of seven DCOs, some of which were existing clearinghouses serving other financial market sectors, and several that were entirely new organizations not previously affiliated with any particular trading facility. In addition, the Commission has received notices from thirteen new ventures of their intent to operate exempt markets, three as exempt boards of trade and ten as exempt commercial markets.

Domestic futures and options volume has almost doubled over the last few years, and reached over one billion contracts traded in 2003. New contract filings have increased more than 500% during this time period, and the regulatory delay in listing the products after filing has dropped from an average of almost 70 days in 1998, to one day for 99% of the new contracts listed last year due to the certification procedures now available to exchanges.

While the number of FCMs has stayed relatively stable--203 at the end of fiscal year 2000 versus 205 at the end of fiscal year 2003--as noted above the amount of contracts and dollar volume traded by FCMs has increased dramatically in the last several years. During the same timeframe, the number of CFTC-registered CPOs and the commodity pools they sponsor, operate, or advise, has grown significantly. At the end of fiscal year 2000, there were 1,624 registered CPOs operating 1,953 commodity pools. These numbers grew to 2,059 CPOs operating 3,244 commodity pools at the end of fiscal year 2003. In 2003, commodity pools held approximately \$450 billion in net assets.

Alliances between exchanges and clearinghouses have shifted leading to market-driven clearing links and common clearing platforms, which provide capital savings through efficiencies such as portfolio margining. Certain OTC business is also now cleared, adding an important element of safety and soundness to this important sector of the economy. New and traditional exchanges alike have embraced technology, and electronic trading has soared from less than 10% of the total volume in 1998, to almost 50% of the total last year, with expectations that this upward trend will continue.

The interest of foreign entities willing to invest in U.S. markets has also risen. Two U.S. designated contract markets are directly or indirectly owned by European exchanges. A U.K. clearinghouse was approved to clear transactions executed on one of the new U.S. exempt commercial markets, and just this week, the Commission expanded its designation to allow it to clear transactions executed on U.S. designated contract markets. In addition, a U.S. clearinghouse has a request pending that, if approved, would allow U.S. customers to clear, through its clearing members, futures and options traded on a German exchange.

This modernized regulatory environment, coupled with market demand, has yielded more platforms, more choices, and more competition than ever before, which has fostered capital efficiencies through new strategic alliances and has resulted in enhanced customer service and lower transactional fees.

Enforcement Efforts

Another benefit to the markets and to the public that resulted from the CFMA was the clarification of the Commission's jurisdiction with respect to retail foreign currency ("forex") transactions. Prior to the CFMA, the Commission's authority to shut down foreign currency bucket shops had been called into question due to differing court opinions interpreting the scope of the Treasury Amendment, a provision of the CEA which excluded the inter-bank foreign currency market from the Commission's jurisdiction. Recognizing that this had created a gap in the law, Congress granted to the CFTC explicit authority to prosecute illegal, off-exchange forex futures and options offerings to the retail public. Following this important clarification in the law, the Commission launched an intensive enforcement initiative to root out and prosecute unscrupulous operators of fraudulent forex bucket shops. The Commission also approved rules adopted by the NFA last year that require their forex dealer members to take responsibility for the activities of any unregulated solicitors they may deal with. The Commission continues to work with the NFA to identify ways in which our supervision of forex activity may be improved.

Since passage of the CFMA, the Commission has filed 61 enforcement actions in the forex area, and has been awarded civil monetary penalties totaling over \$100 million, as well as restitution and disgorgement judgments totaling more than \$62 million. Many of these cases have resulted in additional criminal charges through the cooperative efforts of our Division of Enforcement and state and federal criminal authorities.

The Commission has also aggressively pursued those who manipulated or attempted to manipulate the energy futures markets. Since 2002, the Commission has opened dozens of investigations in this area, which, as I mentioned earlier, has resulted in 16 actions filed and almost \$200 million in civil monetary penalties collected to date. I am happy to report that 97%

of the energy investigations we opened in 2002 have been resolved.

Security Futures Products

Another notable aspect of the CFMA was the legalization of security futures products ("SFPs"), which are futures contracts based on individual stocks or narrow stock indices. The legislation defined SFPs as both futures and securities and directed the CFTC and the Securities and Exchange Commission ("SEC") to share oversight responsibility for their trading under a primary regulator and notice regulator regime intended to avoid duplicative or overly burdensome requirements on market participants. Futures based on broad-based stock indices, which have been permitted since 1982, remain under the exclusive jurisdiction of the CFTC.

Although the two agencies were able to jointly formulate rules that allowed SFPs to begin trading in a timely manner, the products have not been as successful as some had predicted. I believe that this is due in part to the lack of a risk-based portfolio margining regime for SFPs similar to that used in other futures markets. Another issue that remains outstanding is the promulgation of joint rules to permit the trading of foreign SFPs. It is my hope that we can reach agreement with the SEC on these and other issues in the near future

Ongoing Initiatives

While the major work of implementing the CFMA is done, the Commission continually looks for ways to further the spirit and purposes behind the legislation, to lift regulatory burdens where they no longer serve a legitimate purpose, and to replace obsolete, prescriptive requirements with principles-based oversight that allows for innovation and fair competition. One area in which we are focusing is to modernize our oversight of exchanges, clearinghouses, and other self-regulatory organizations with risk-based examination cycles and risk-focused reviews. Similar to the approach of other federal financial regulators and certain overseas financial supervisors, both the scheduling and scope of the CFTC's supervisory reviews will now be based on careful analysis of the underlying risks to which an institution is exposed and the controls it has in place to address those risks. This approach promises to better utilize staff resources and to facilitate even greater financial integrity and risk management within the firms and clearinghouses that are the backbone of the futures clearing system.

In addition, in keeping with the CFMA's directive that the public interests embodied in the futures markets be served through a system of effective self-regulation of trading facilities, clearing systems, market participants, and market professionals under the Commission's oversight, I announced last year that the Commission would review the roles, responsibilities and capabilities of the industry's self-regulatory organizations ("SROs"). This was not because of any particular concern or perceived problem, but because I thought it was the prudent thing to do given the CFMA's emphasis on self-regulation, and the structural changes occurring in the industry such as the move by exchanges towards demutualization. Since the initiation of the SRO study, Commission staff has interviewed more than 100 individuals representing FCMs, exchanges, and DCOs. Staff has also interviewed industry executives, academics, consultants and individuals associated with securities-side entities.

Based on these interviews, we identified two issues for immediate attention: (1) ensuring the confidentiality of certain information obtained by SROs in the course of their self-regulatory activities; and (2) examining the cooperative regulatory agreement by which SROs coordinate compliance examinations of FCMs. As part of that review, the Commission recently issued a request for comment on proposed amendments to that agreement. The Commission is also moving forward with a second phase of the study, which will focus on governance issues. A request for comment soliciting views on a number of issues in that area will go out soon.

Conclusion

By moving front-line accountability for how markets operate and what they trade to the marketplace, the CEA, as amended by the CFMA, permits regulatory resources to be refocused on strong oversight, risk-based inspection, and swift and sure enforcement. It has been an exciting time to be at the Commission as the industry has evolved over the last few years to incorporate new technologies into their business models and meet the challenges of competition. In my opinion, the new regulatory framework brought about by enactment of the CFMA has been a success. I would hope, therefore, that as the time for reauthorization approaches, any legislative amendments that may be considered be approached cautiously and pursued only after a full debate by all interested parties. The Commission looks forward to working with the Committee on this upcoming project.

I would like to close by expressing how proud I am of the dedicated men and women at the Commission who have worked tirelessly over the last three-and-a-half years to reshape our regulatory framework to achieve the goals expressed by Congress and to timely process the many new exchange and clearinghouse applications we have received. We have worked very hard to get things right. Thank you for the opportunity to testify. I will be happy to answer any questions you may have.

