

Mr. Chairman, thank you for this opportunity to testify on behalf of the New York Board of Trade regarding the reauthorization of the Commodity Futures Trading Commission (CFTC). My name is Frederick Schoenhut and I am Chairman of the Exchange.

In 2004, the Coffee, Sugar & Cocoa Exchange, Inc. (CSCE - founded in 1882) and the New York Cotton Exchange (NYCE - founded in 1870) formally became one exchange, the New York Board of Trade (NYBOT or "Exchange"). Like its predecessor exchanges, NYBOT is a not-for-profit membership organization established under New York law.

NYBOT is the premier world market for futures and options in cocoa, coffee, cotton, orange juice, and sugar. The Exchange also provides markets for futures and options based on the U.S. Dollar Index, Russell U.S. Equity Indexes, Reuters/CRB Futures Index and currency cross rate contracts. While these financial markets exhibit different underlying characteristics than the agricultural commodities that dominate the Exchange, they all provide reliable tools for price discovery, price risk management and investment. In 1994, NYBOT established a trading floor in Dublin; the first U.S. exchange open outcry trading facility in Europe.

Under the Commodity Exchange Act (CEA), NYBOT's markets are "designated contract markets (DCMs)." This means the Exchange has demonstrated to the Commodity Futures Trading Commission (CFTC or "Commission") that it has systems in place to ensure a transparent and fair trading environment and to protect the financial integrity of transactions. As a DCM, NYBOT establishes rules that govern trading, monitors for compliance, and enforces its rules through disciplinary actions, and the CFTC regularly reviews the Exchange's implementation of these functions.

The concept of self-regulation, long embodied in the CEA, was strongly reinforced and expanded by the Commodity Futures Modernization Act of 2000 (the "CFMA"). Specifically, in Section 2 of the CFMA Congress declared that among the purposes of the Act are:

1. to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the CEA; and
2. to transform the role of the CFTC to oversight of the futures markets.

The CFMA was the culmination of four years of work by the Congress. It provided flexibility for exchanges to decide how to best structure their businesses around a set of "Core Principles." The CFTC provides oversight, rather than promulgating prescriptive regulations and second-guessing exchange decisions.

We believe the CFMA is working as intended, allowing markets to be competitive by modernizing and streamlining the regulatory system. Thus, we believe the CEA does not need amendment and recommend a clean, 5-year reauthorization bill.

## Market Participants

Market participants are generally categorized as "hedgers" and "investors." Hedgers are commercial firms that trade futures and options to reduce their price risk exposure in the cash market, to protect their profit margins, and to assist in business planning. In a mature market such as sugar or cotton, nearly all levels of the marketing chain of the underlying commodity are represented at one time or other in the trading ring. For example, in the case of cotton, this would include producers, ginner, merchants, shippers, textile manufacturers, and retailers. Hedgers also play an important role in Exchange governance, by serving on commodity committees that review contracts to make sure their terms and conditions are up-to-date with commercial practices.

Investors are attracted to the markets because there are opportunities to profit from price changes as contracts are traded. Because they enlarge the pool of traders, it is easier for market participants to find a buyer or seller and market liquidity is improved. They are therefore critical to the risk management and price discovery functions of the markets.

Investors typically trade through futures commission merchants (FCMs) or through introducing brokers that have clearing relationships with FCMs. Investors also participate in the markets through commodity funds, which are managed by commodity trading advisors (CTAs). All such individuals, firms and their associated persons must be registered with the CFTC and hold membership in the National Futures Association, a self-regulatory organization registered with the CFTC that is charged with enforcing ethical standards and customer protection in the futures industry.

On the floor of the Exchange, trades are executed by floor traders (also called "locals"), who trade for their own accounts, and floor brokers, who execute customer orders. Floor brokers may be "dual traders," meaning they execute customer orders and trade for their own account. The participation of locals and dual traders is critical for maintaining liquidity on NYBOT's markets. All floor traders and brokers must be registered with the CFTC and guaranteed by a

member of the New York Clearing Corporation (NYCC). NYBOT is the sole shareholder of NYCC, which is registered with the CFTC as a derivatives clearing organization ("DCO").

The membership of the Exchange includes representatives from all segments of the commercial industries served by NYBOT markets, as well as FCMs, floor brokers, floor traders and CTAs. A full membership allows a member to trade any of the Exchange's futures and options contracts. The Exchange also issues options trading permits that allow the trading of options contracts and "FINEX" permits that allow the trading of financial products in New York or in Dublin.

### Trade Matching, Monitoring and Clearing

On NYBOT, all of the details of each trade are entered by the clerks for floor traders and brokers into the NYBOT Trade Input Processing System (TIPS), which automatically matches trades on an ongoing basis. When trades are matched, they are allocated to the appropriate NYCC clearing members that are carrying the relevant account. By the end of each day, all trades are financially settled by the NYCC, and the clearinghouse assumes the opposite side of the clearing members' positions, serving as buyer to every seller and seller to every buyer. Since the NYCC provides financial security for all transactions, counterparty credit risk is not a concern.

The strength of the futures contract is drawn from the clearinghouse guarantee of performance. The safeguards used by the NYCC include stringent financial requirements and clearing member position limit, as well as guarantee deposits from its clearing members.

TIPS data also is used by the Exchange to establish an audit trail, which provides the sequence and execution time of each trade, to the nearest minute. Programs are run to identify any sequences that may indicate trading ahead of a customer's order or other illegal trading activity. Thus, these systems provide powerful monitoring and enforcement tools, and their existence deters violations.

### Exchange Governance

NYBOT's Board of Governors establishes and interprets the Exchange's rules and regulations and approves all rule changes and contract modifications. Exchange committees, comprised of

members and public members, work with NYBOT staff to develop policy and recommend changes to the contracts and operations. Our trade committees have the ultimate authority with respect to contract specification and must approve any changes before they may be implemented by the Board.

The senior management of NYBOT, under the leadership of the President and CEO and the oversight of the Board of Governors, is responsible for the day-to-day management of the Exchange.

Consistent with Core Principle 16, the NYBOT Board consists of 25 voting governors and one non-voting governor (the president, who is the sole staff representative to the Board). NYBOT By-Laws currently require representation from each major community in its membership on its Governing Board, as well as public members. Therefore, governors include members who represent the commercial industries associated with the products traded on the Exchange, members who trade for themselves or others on the trading floor, FCMs and public governors.

Diversification of Board membership is beneficial to protect the public interest and the economic self-interest of the markets. It provides the Board with a level of expertise that can only be provided by people who are actively engaged in the trading of the products and also allows the Board to take a range of views into consideration before reaching a decision.

As a matter of general corporate law, the fiduciary duty of a director is to the corporation itself and not to any particular constituency. Thus, NYBOT's reason for diversification is not to have spokespersons on the Board for different Exchange constituencies; rather, it is to assure that a range of expertise is represented during the deliberative process.

Five (equal to 20%) of NYBOT's voting governors are denominated as "Public Governors," who are individuals that are not NYBOT members or affiliated with NYBOT member firms. These Public Governors are appointed by the Board. The current Public Governors include a faculty member of a prestigious school of business administration, a principal in a merger and acquisition firm, a consultant on legislative affairs, a senior official at a bank and a commodity trading adviser.

How Board members are chosen, whether to have such diversification, and how representation of various communities should be allocated, are matters for each DCM to determine for itself in light of its own particular circumstances.

## Disciplinary Procedures

DCM Core Principle 2 states that an exchange "shall monitor and enforce compliance with the rules of the contract market." The CFTC conducts regular rule enforcement reviews to determine whether an exchange is meeting this requirement. We believe this current system works well and should not be changed.

NYBOT has a disciplinary committee comprised of both members and non-members, called the "Business Conduct Committee" (or "BCC"). This Committee serves several functions, including receiving and reviewing written reports concerning possible rule violations from the Compliance Department staff and determining whether a rule violation may have occurred in any particular instance. BCC members also serve as the Hearing Panel in the event a disciplinary matter is adjudicated.

Each review as to whether a rule violation may have occurred is conducted by a subcommittee of the BCC consisting of one non-member of NYBOT and seven NYBOT members drawn from different exchange communities. The subcommittee may refer the matter to the Compliance Department for further action, enter into or approve a settlement agreement with the accused, or refer the matter to a formal hearing. If a matter is referred to a formal hearing, the proceeding is conducted by a separate panel, consisting of three or five BCC members (not including any of those involved in the preliminary determination to refer the matter for a formal hearing), one of whom is a non-member and the others of whom are drawn from different exchange communities. Individuals having a relationship to the respondent are excluded from both the subcommittee and the trial panel. In this way each pre-trial subcommittee and each trial panel has both expertise and impartiality.

Most cases presented to the BCC are very technical in nature and require a strong knowledge of our rules and understanding of trading practices. Were this system changed by requiring a majority of the disciplinary subcommittees or trial panels to be comprised of non-members, it would deprive the system of needed expertise. Moreover, it would be difficult to attract regular panel participants without adequate compensation, thereby placing smaller exchanges that cannot afford to pay public members attractive sums for serving on such panels at a disadvantage. Compensating individuals who perform these functions can be seen as just creating a different potential conflict of interest.

While the NYBOT compliance system has worked successfully for many years, undoubtedly other systems might be employed at other exchanges to equally good effect, and it should be the decision of each exchange as to what system to employ.

## Conflicts of Interest

DCM Core Principle 15 states that an exchange "shall establish and enforce rules to minimize conflicts of interest in the decisionmaking process of the contract market and establish a process for resolving such conflicts." The details as to how that is done is, and should continue to be, left to each exchange.

The basic approach taken by NYBOT is to require disclosure of conflicts and disqualify participants who are conflicted. In the case of a proceeding involving a "named party in interest," NYBOT Rule 6.05 provides that any person having any one of a number of specified relationships with the person who is the subject of the proceeding is barred from participating in the proceeding. In cases not involving a named party in interest, NYBOT Rule 6.06 provides that persons having one of a defined category of conflicts of interest may participate in a discussion after disclosing the nature of the conflict, but may not vote on the outcome. In addition, NYBOT is, and presumably other SROs are also, subject to conflict of interest principles contained in state corporate law.

## Challenges and Opportunities

### Protection of Market Data Rights

While Congress and the CFTC have effectively facilitated a level playing field to ensure that US exchanges can compete internationally, new threats and challenges face us, today. In the global marketplace, protecting the valuable property rights held by exchanges with regard to their market data is an emerging challenge.

Real-time market data include a continuous stream of prices, as well as volume, open interest, and opening and closing ranges for actively traded contracts. Exchanges sell this information to licensed vendors, which in turn sell the information to various clients throughout the world. Fees from these vendor contracts provide about one-fourth of NYBOT's annual income, with the other income primarily generated from trading fees. This income is used to maintain the systems and platforms that allow NYBOT's markets to function effectively and efficiently so they can serve their intended price discovery and risk management functions. Anything that threatens the income from vendor contracts actually threatens the viability of the Exchange.

Over the past few years, we found our proprietary, real-time market data being published on a

website in China. Yet, none of our vendors have reported selling this information to the owner of the website. Thus, we are not collecting the fees. We have joined with several other US futures exchanges to investigate this problem and wrote to the US Trade Representative to report this apparent piracy as the USTR reviews China's compliance with intellectual property rights agreements.

### Warehouse Act of 2002 Creates New Opportunity

In 1990, CSCE created a computerized, physical commodity delivery system that addressed sampling, quality, weighing, title transfer, and confirmation of the title status of deliveries. It streamlined the delivery process by eliminating many duplicate paper records, phone calls and faxes, saving time and money for the Exchange and its market users.

In 2003, NYBOT transformed this closed system into "eCOPS" - a web-based Electronic Commodity Operations and Processing System. It can process all forms related to coffee and cocoa deliveries using the internet. With enactment of the 2002 Warehouse Act, we were able to move eCOPS a step further. USDA recognized NYBOT as an official provider of Electronic Warehouse Receipts for coffee. All Exchange coffee deliveries have been transferred to the new system and it is also being used for non-exchange certified coffee. Through these types of innovations, NYBOT serves the broader needs of its market users.

### Connecting with Customers

Price volatility is a challenge for agricultural-related businesses in the United States and around the world. Yet, many producers and businesses are not fully aware of or comfortable with risk management tools. Bridging this knowledge gap is an important function of the educational materials and programs designed by the Exchange.

There are many examples. In cooperation with Cotton, Inc., NYBOT sponsors a series of options seminars to provide step-by-step guidance on the use of cotton options for risk management. For our international products, we have worked with UNCTAD, the World Bank and directly with producers and firms in developing countries to assist them in utilizing futures and options. Business and government leaders from many countries and US industries regularly visit the Exchange and participate in educational programs, as well.

## Looking Forward

On September 11, 2001, NYBOT was the only exchange completely destroyed in the World Trade Center terrorist attack. Fortunately, one of its predecessor exchanges had built a back-up trading floor in Long Island City following the 1993 bombing of the World Trade Center. Using this facility, NYBOT opened trading on September 17, 2003.

In September 2003, NYBOT returned to lower Manhattan and moved into its new facility at the World Financial Center. In 2004, we hit a record trading volume of approximately 32 million contracts, representing an increase over 2003 volume of 32%.

Mr. Chairman, we thank the CFTC and the Congress for your support after the disaster. And, we thank the members of this Committee and the Congress for the assistance you gave New York and our Exchange, allowing us to rebuild. I would be happy to answer any questions you may have.