Written Statement of
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New York Mercantile Exchange, Inc.
Commodity Futures Trading Commission
Public Hearing on Exempt Commercial Markets
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Acting Chairman Lukken and other CFTC commissioners, my name is Jim Newsome and I am the President and Chief Executive Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products, and has been in the business for more than 135 years. NYMEX is a federally chartered marketplace, fully regulated by the CFTC both as a "derivatives clearing organization" (DCO) and as a "designated contract market" (DCM). These categories were established by the Commodity Futures Modernization Act of 2000 (CFMA), which was enacted by Congress in December 2000.

On behalf of the Exchange, its Board of Directors and shareholders, I want to express our appreciation to the CFTC for holding this public hearing on exempt commercial markets (ECM). Over the last several months, the role of ECMs has received a lot of attention on Capitol Hill and elsewhere. During this period, NYMEX has observed a broad and growing consensus that certain products traded on ECMs and DCMs are tightly linked and effectively result in one broader market. Consequently, NYMEX, along with some legislators and regulators, have concluded that there is a need for appropriate statutory change to provide effective regulatory oversight of markets that are of critical importance to U.S. consumers and to the overall economy. The debate over the changes in the marketplace is now largely settled. The real question becomes the appropriate statutory response, and NYMEX believes that the hearing today is quite timely and can provide a real public service on this important policy question.

Overview

NYMEX believes that, in general, the CFMA has been an outstanding success. The Exchange further believes that the tiered statutory structure for trading facilities has been effective in many respects. However, a series of profound changes have occurred in various OTC markets since the passage of the CFMA, including technological advances in trading, such that the regulated DCM, NYMEX, and the unregulated ECM, Intercontinental Exchange (ICE), have become highly linked trading venues. As a result of this phenomenon, which could not have been reasonably predicted only a few short years ago, the current statutory structure no longer works for certain markets now operating as ECMs. Specifically, the regulatory disparity between the NYMEX and certain ECMs, particularly the ICE, which are functionally equivalent to each other, has created serious challenges for the CFTC and for NYMEX in its capacity as a self-regulatory organization. NYMEX has also concluded that ECMs such as ICE, which function more like a traditional exchange and which are linked to an established exchange, should be subject to regulation of the CFTC for certain products in the form of large trader reporting, position limits/accountability levels and self-regulatory responsibilities.

In addition, the continuing exchange-like aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple implications for other clearing members and for various clearing organizations that share common clearing members. Consequently, legislative change is necessary to address the real public interest concerns created by the current structure of the over-the-counter (OTC) electronic gas market and the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

Statutory Review

The CFMA provided greater legal certainty for OTC derivatives transactions, and established a number of new statutory categories for trading facilities. It shifted away from a "one-size-fits-all" prescriptive approach to futures exchange regulation to a more flexible approach that included the use of core principles for DCMs and that confirmed the CFTC's role as an oversight agency (rather than a "command and control" agency that must issue affirmative approval before any new innovations could be introduced to the market).

The CFMA also added new section 2(h) to the Commodity Exchange Act (CEA), which exempted energy commodities from CFTC regulation and allowed the trading of energy swaps on an electronic trading platform. Under CFTC rules, these platforms are known as "Exempt Commercial Markets" (ECM). While transactions executed on an ECM generally are subject to anti-fraud and anti-manipulation authority, the ECM itself is essentially exempt from all substantive CFTC regulation and oversight. In addition, the ECM by statute has no affirmative requirements to engage in any self-regulatory activities to monitor its markets or otherwise seek to prevent any manner of market abuses.

As a note, the CFMA was enacted following the issuance of a report by the President's Working Group on Financial Markets (PWG) that was undertaken at the direction of Congress. Specifically, that study focused upon OTC derivatives markets and provided legislative recommendations to Congress. The PWG Report, entitled "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," was issued in 1999 and focused primarily on swaps and other OTC derivatives transactions executed between eligible participants. Among other things, the PWG Report recommended exclusion from the CEA for swap transactions in financial products between eligible swap participants. Yet, the PWG Report explicitly noted that "[t]he exclusion should not extend to any swap agreement that involved a non-financial commodity with a finite supply." (Report of the PWG, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act" (November 1999) at p. 17.). However, in a footnote, the PWG stated that "[t]he CFTC would retain its current exemptive authority for swap agreements that involve a non-financial commodity with a finite supply." (Id.).

Section 2(h) was intended to provide legal certainty to energy swaps traded on or off a trading facility by clarifying that bilateral contracts, agreements or transactions in exempt commodities between eligible commercial entities were not subject to CFTC regulation, even if the contracts were cleared, but remained subject to the CFTC's anti fraud and anti manipulation provisions. The CFTC implemented Section 2(h)(3) in Part 36 of its regulations by creating the category of markets known as ECMs.

NYMEX believes that the CFMA generally has been a major success. Moreover, the Exchange continues to be broadly supportive of the key components of that landmark legislation, including the provision of legal certainty for traditional bilateral OTC swaps executed between appropriate market participants. NYMEX also believes that the tiered statutory approach to trading facilities has been effective in many respects. The tiered structure was intended to impose a degree of regulation necessary to the market place based on the product traded and the market participants. Thus, at the highest tier of regulation, the DCM category, 18 core principles apply on an ongoing basis and the market is open to all products and all market participants and trades are or can be intermediated.

The DTEF is at the second tier and is subject to 9 core principles. The market generally can trade products that are highly unlikely to be susceptible to manipulation, and it is not open to all market participants. Under one version of the DTEF, market participants must be eligible contract participants or trade through a registered FCM with net capital of at least $20,000,000. Under the other version of DTEF, participants are limited to eligible commercial entities. The DTEF category to date has not been utilized by the derivatives industry.

The third market tier, for exempt markets, includes ECMs and Exempt Boards of Trade (EBOT). EBOTs generally are limited to excluded commodities and are unregulated. The ECM tier is open only to eligible commercial entities, trades products other than financial derivatives and agricultural commodities and also as a facility is completely unregulated. Transactions on the ECM are subject only to the CFTC's antifraud and anti-manipulation authority. Approximately 18 entities have filed notification with the CFTC of their intention to operate as an ECM, and an additional six companies have filed notification of their intention to operate as an EBOT.

The ECM category was designed for commercial market participants who were in the business of making and taking delivery of the physical product, and who would be limited to engaging in principal-to-principal trading with each other. The exemption from effective CFTC oversight and regulation of the ECM trading facility built on the CFTC's existing 1993 Energy Exemption for OTC bilateral energy swaps between commercial entities. There was a view at the time that there was not a public policy need to protect large commercial participants from transactions with other large and similarly situated commercial entities. However, the large-scale exemption of ECMs from effective CFTC oversight did not contemplate that the trading activities of commercial players on such trading facilities would have spill-over or ripple effects on the broader energy markets and ultimately affect consumers.

Subsequent to the passage of the CFMA in late 2000, derivatives markets, especially natural gas derivatives markets, evolved in just a few short years to an extent and at a rate that would have been very difficult to predict in 2000. When the CFTC was in the midst of proposing and finalizing implementing regulations and interpretations for the CFMA in 2001, even shortly following the wake of the Enron meltdown in late 2001, the natural gas market, for example, continued to be largely focused upon open outcry trading executed on the regulated NYMEX trading venue. At that time, NYMEX offered electronic trading on an “after-hours” basis, which contributed only approximately 7-10% of overall trading volume at the Exchange. Electronic trading (of standardized products based upon NYMEX’s natural gas contracts) was at best a modest proportion of the overall market. Moreover, it was more than six months following the Enron meltdown before the industry began to offer clearing services for OTC natural gas transactions.

But, in determining to compete with NYMEX, ICE, which as noted operates as an ECM, not only copied all of the relevant product terms of NYMEX’s core or flagship natural gas futures contract, but also misappropriated the NYMEX settlement price for daily and final settlement of its own contracts. As things stand today, natural gas market participants have the assurance that they can receive the benefits of obtaining NYMEX’s settlement price, which is now the established industry pricing benchmark, by engaging in trading either on NYMEX or on ICE.

For some period of time following the launch of ICE as a market, ICE was the only trading platform that offered active electronic trading during daytime trading hours. In September of 2006, NYMEX began providing “side-by-side” trading of its products--listing products for trading simultaneously on the trading floor and on the electronic screen. Since that time, there has been active daytime electronic trading of natural gas on both NYMEX and ICE. The share of electronic trading at NYMEX as a percentage of overall transaction volume has shifted dramatically to the extent that electronic trading now accounts for 80-85% of overall trading volume at the Exchange.

The existence of daytime electronic trading on both NYMEX and ICE has fueled the growth of arbitrage trading between the two markets. Thus, for example, a number of market participants that specialize in arbitrage activity have established computer programs that automatically trade the spread between the two markets and that transmit orders to one market when there is an apparent price imbalance with the other market or where one market is perceived to offer a better price than the other market. As a result, there is now a relatively consistent and tight spread in the prices of the competing natural gas products. Hence, the two competing trading venues are now tightly linked and highly interactive and in essence are simply two components of a broader derivatives market. As the CFTC itself acknowledged in its recent proposed rule-making, there is now "a close relationship among transactions conducted on reporting markets and non-reporting transactions." (72 Fed. Reg. 34, 413, at 34,414 (2007) (proposed June 22, 2007.)

Because ICE price data are available only to market participants, NYMEX does not have the means to establish conclusively the extent to which trading of ICE natural gas swaps contributes to or influences or affects the price of the related natural gas contracts on NYMEX. However, what is clear is that, as a consequence of the extensive arbitrage activity between the two platforms and ICE's use of NYMEX's settlement price as well as other factors, the two natural gas trading venues are now tightly linked and highly interactive. These two trading venues serve the same economic functions and are now functionally equivalent to each other. NYMEX staff has been advised that, during most of the trading cycle of a listed futures contract month, there is a range of perhaps only five to twelve ticks separating the competing NYMEX and ICE products. (The NYMEX NG contract has a minimum price fluctuation or trading tick of $.001, or .01 cents per mmBtu.) NYMEX staff has also been advised by market participants who trade on both markets that a rise (fall) in price on one trading venue will be followed almost immediately by a rise (fall) in price on the other trading venue. This may occur because prices rise first on ICE and then follow on NYMEX, or because prices rise first on NYMEX and then follow on ICE. These observations of real-world market activity support the conclusion that trading of ICE natural gas swaps do in fact contribute to, influence and affect the price of the related natural gas contracts on NYMEX. No one could have predicted in 2000, when the exemption was crafted for energy swaps, how this market would evolve.

The ICE market now has a significant market share of natural gas trading, and a number of observers have suggested that most of the natural gas trading in the ICE Henry Hub swap is subsequently cleared by the London Clearing House, the clearing organization contracted by ICE to provide clearing services. Thus, there is now a concentration of market activity and positions occurring on the ICE market, as well as the exchange-like concentration and mutualization of financial risk at the clearing house level from that activity.

As previously noted, at the time that the CFMA was being formulated in Congress, the presumption was that larger, sophisticated market participants did not need a regulatory agency to protect them from trading with each other. Also, there obviously were no perceived concerns at that time about potential impact on the public interests implicated by trading on ECMs. Yet, what has become clear in the last several years is that the changing nature and role of ECM venues, such as ICE, do now trigger public interest concerns in several ways, including with respect to the multiple impacts on other trading venues that are regulated as well as through the exchange-like aggregation of financial risk.

The CFMA, however, did contemplate the possibility of ECMs becoming price discovery markets and, accordingly gave the CFTC authority to make the determination that an ECM performed a significant price discovery function and to require the dissemination of prices, trading volume and other trading data. This authority has never been exercised despite the tremendous growth in the volume of trading in the natural gas contract on ICE and the clear linkage between that market and the NYMEX. While the dissemination of market data from ICE would be useful, the CFTC's existing statutory authority does not go far enough in order to address the significant regulatory problems identified by the Amaranth case. Thus, a legislative change is required to give the CFTC a certain level of authority over these markets as needed to address the identified public interest concerns.

NYMEX does not have any ongoing formal relationship with ICE. In particular, as ICE and NYMEX are in competition with each other, there are currently no arrangements in place, such as information-sharing, to address market integrity issues. NYMEX as a DCM does have affirmative self-regulatory obligations; ICE as an ECM has no such duties. Yet, from a markets perspective, the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive; trading activity and price movement on one venue can quickly affect and influence price movement on the other venue.

As one case example of concerns created for NYMEX as a DCM because of the differences in the level of regulation, NYMEX staff was aware of and monitored all open positions that Amaranth maintained in NYMEX trading venues, including the physically delivered NG natural gas futures contract. NYMEX conducted regular reviews of Amaranth's open positions in excess of position accountability levels prescribed by NYMEX rule. NYMEX staff members directed Amaranth in early August 2006 to reduce its open positions in the first two nearby contract months based upon what they believed to be a significant concentration in NYMEX markets in Natural Gas (relying upon an NG "futures only" approach). NYMEX believes that such a directive was prudent and also was effective with respect to reducing positions carried on our platform. NYMEX maintains no information sharing agreement of any kind with ICE; the Exchange also observes that, during the period in question, the CFTC was not receiving any regular information from ICE as to positions on its platform. Thus, a shift of positions by Amaranth from NYMEX to ICE was undetectable at that time both by NYMEX and the CFTC. NYMEX believes that the outdated provisions of the CEA concerning ECMs do raise concerns not only for DCMS and for regulators but also for market participants and indeed for the general public as well.

It has become apparent to NYMEX that the broad structural issues raised by changes in the marketplace can not be addressed effectively at the level of individual exchanges. For example, earlier this year, in an effort to cooperate with the Federal Energy Regulatory Commission and following consultation with CFTC staff, NYMEX issued a compliance advisory in the form of a policy statement related to exemptions from position limits in NYMEX Natural Gas (NG) futures contracts NYMEX adopted this new policy on an interim basis in a good faith effort to carry out its self-regulatory responsibilities and to address on an individual exchange level the market reality demonstrated by Amaranth's trading on both regulated and unregulated markets.

However, this experience has had an adverse impact on NYMEX's trading venues and is seemingly creating the result of shifting trading volume (during the critically important NG closing range period at NYMEX on the final day of trading) from our regulated trading venue to unregulated trading venues. Specifically, the new interim policy implemented by NYMEX on a good-faith basis has: 1) reduced volume on NYMEX during the critical 30-minute closing range period; 2) presumably shifted volume from the regulated to the unregulated trading venues; and 3) failed to solve the structural imbalances brought to light by Amaranth's trading. In addition, this policy could create new problems by diminishing the vitality of the natural gas industry's pricing benchmark. Consequently, NYMEX now believes strongly that legislative change is both necessary and appropriate.

NYMEX believes that a targeted approach that directly addresses the specific issues raised by these industry changes would be the most effective policy response and would provide the greatest assurance of limiting the unintended consequences of more sweeping or draconian changes. Thus, NYMEX believes that a heightened level of CFTC regulation and oversight should be mandated for certain products listed on a particular ECM triggering the public policy concerns noted above. NYMEX does not believe that the case has been made for extending such heightened regulation to other products listed on such an ECM, to other ECMs that have not triggered these policy interests and concerns, or to the traditional bilateral OTC market.

In particular, for those products trading on ECMs that have triggered public policy interests and concerns, NYMEX believes that the CEA should be amended to require routine mandated large trader reporting and position accountability requirements for financially settled ECM contracts that are highly linked to and functionally equivalent with regulated DCM contracts. Such ECMs also must be assigned self-regulatory organization duties to police their own markets and to submit applicable rule changes to the CFTC in a manner similar to other regulated entities. NYMEX believes strongly that such statutory changes are necessary and appropriate and would not negatively impact the core price discovery and hedging functions provided by derivatives markets.

At present, the greatest attention has been focused upon energy products listed by ECMs. NYMEX does not believe it would be appropriate to exclude products by category from heightened regulation, as markets may evolve for other products, such as metals or weather derivatives, in a manner similar to the evolution of energy markets.

On the other hand, the targeted approach that NYMEX recommends should not unduly affect the ability of ECMs to be sources of innovation, including with respect to the adoption of new trading technologies. This targeted approach may result in an ECM needing to distinguish on its electronic trading system those products that are subject to CFTC oversight from those products that remain exempt from CFTC regulation.

However, more generally, NYMEX's recommended approach would not appear to require whole-sale changes in an ECM's business model. Finally, it has been suggested in certain quarters that any manner of regulation of an ECM would lead immediately to the shift of trading elsewhere, either to the traditional bilateral OTC market or to less-regulated foreign boards of trade. NYMEX believes that this prospect is improbable for several reasons: 1) market participants will continue to be attracted to markets that offer pools of liquidity for trading in their products; 2) market participants appear to have a preference for the speed and efficiency of electronic trading as compared to the traditional phone bilateral market; and 3) electronic trading systems facilitate the clearing of traded products, which also seems to be the growing preference for OTC participants in a variety of products. Consequently, NYMEX believes that the hypothetical prospect of a worst-case scenario should not be misused to dissuade Congress or the CFTC from undertaking carefully considered and targeted solutions that can effectively fix the current shortcomings of the existing statutory structure.

Conclusion

NYMEX believes that the in general the CFMA has been an outstanding success. The Exchange further believes that the tiered statutory structure for trading facilities has been effective in many respects. However, a series of profound changes have occurred in various OTC markets since the passage of the CFMA, including technological advances in trading, such that the regulated DCM, NYMEX, and the unregulated ECM, Intercontinental Exchange, have become highly linked trading venues. As a result of this phenomenon, which could not have been reasonably predicted only a few short years ago, the current statutory structure no longer works for certain markets now operating as ECMs.

Specifically, the regulatory disparity between the NYMEX and certain ECMs, particularly the ICE, which are functionally equivalent to each other, has created serious challenges for the CFTC and for NYMEX in its capacity as an SRO. NYMEX has also concluded that ECMs such as ICE, which function more like a traditional exchange and which are linked to an established exchange, should be subject to regulation of the CFTC for certain products in the form of large trader reporting, position limits/accountability levels and self-regulatory responsibilities. In addition, the continuing exchange-like aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple implications for other clearing members and for various clearing organizations that share common clearing members. Consequently, legislative change is necessary to address the real public interest concerns created by the current structure of the OTC electronic trading market and the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions that any commissioners may have.