Testimony of Tom Callahan,
CEO, NYSE Liffe U.S.
NYSE Euronext
CFTC Open Meeting to Examine Metals Futures and Options Markets

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Chairman Gensler and Members of the Commission, my name is Tom Callahan and I am the CEO of NYSE Liffe U.S., the U.S. futures trading platform of NYSE Euronext. It is a great honor to appear before you today to discuss regulatory issues raised by the metals futures and options markets.

Launched in September 2008, NYSE Liffe U.S. is registered with the CFTC as a designated contract market and clears its contracts through the Options Clearing Corporation, a registered derivatives clearing organization. The lineage of our exchange traces back to what was once known as "CBOT Metals," which was divested by CME Group in March 2008 so as to preserve competition in the metals market in the face of the pending CME merger with NYMEX/COMEX. NYSE Euronext is working hard to deliver on this objective to promote fair and effective competition, which will be an important theme today as we discuss the importance of promoting competition in the context of position limits in the U.S. metals futures market.

Since that time, NYSE Liffe U.S. has competed by providing a fully electronic, liquid market for physically deliverable 100 ounce gold futures, 5,000 ounce silver futures, options on gold and silver futures, and mini-sized gold and silver futures. Last fall, we also added a suite of equity futures products to our platform based on the successful MSCI indices and we soon hope to list other competitive products in the coming months, including U.S. interest rate contracts.

Our parent company is NYSE Euronext, a leading global operator of financial markets in the U.S. and Europe with exchanges that trade equities, futures, options, fixed-income and exchange-traded products. With more than 8,000 listed issues, the equity markets of NYSE Euronext represent nearly 40 percent of the world's equities trading, the most liquidity of any global exchange group.

While our parent is historically known for its equity exchanges, you may be surprised to know that nearly one-third of the company's revenues comes from derivatives trading—anchored primarily by NYSE Liffe in London, the world's third-largest derivatives exchange. Growing our derivatives business is a key strategic goal for our parent company—both through the start-up exchange that I lead—NYSE Liffe U.S. and our well-established exchange in London—NYSE Liffe.

While NYSE Euronext views itself as a unified global financial company, the regulation of our company—not surprisingly—is administered according to our functional parts. As I mentioned, NYSE Liffe U.S. is regulated with the CFTC as a designated contract market (DCM). Our equity exchanges in the U.S. are regulated as registered securities exchanges by the SEC. Our European exchanges are regulated by their respective home country regulators, which include the FSA in the United Kingdom, the AMF in France, the CMVM in Portugal, the AFM in the Netherlands, and the CBFA in Belgium. In addition, the Euronext exchanges are subject to a European college of regulators, which serves to coordinate our European regulatory oversight.

Undoubtedly, we are one of the most regulated global financial firms around but strongly believe that regulation—if properly administered—adds value to our underlying business model. Today I would like to address a couple of areas of focus for the Commission as you review the regulation of the metals complex to ensure that these markets are fair and competitive and that these products are free from manipulation and fraud for investors.

Metals Futures on NYSE Liffe U.S.:

NYSE Liffe U.S. provides a fully electronic, liquid, transparent market for physically deliverable 100 ounce gold futures, 5,000 ounce silver futures, options on gold and silver futures, and mini-sized 33.2 ounce gold and 1,000 ounce silver futures. We directly compete with the CME's Comex exchange, which is the more established exchange for these products. Currently, the metals contracts listed on NYSE Liffe U.S. have around 5% percent of the total U.S. futures market in volume. That said, given that the OTC bullion market is multiple times larger than the exchange-traded market, we estimate that precious metals contracts listed on both U.S. futures exchanges combined comprise a small fraction of the total precious metals market globally.

The National Futures Association, a registered futures association with the CFTC, conducts day-to-day market surveillance for NYSE Liffe U.S. In its capacity as a CFTC registered DCM and self-regulatory organization (SRO), NYSE Liffe U.S. places position limits on its 100 ounce gold futures, 5,000 ounce silver futures, options on gold and silver futures, and mini-sized 33.2 ounce gold and 1,000 ounce silver futures products. It should be noted that the current levels of position limits set forth on NYSE Liffe U.S. are extremely conservative and we believe protect the market from manipulation and excessive speculation. Guidance from the CFTC indicates that these should be no more than 25% of deliverable supply in the deliverable month. NYSE Liffe U.S.' limits are well below this level, equating to no more than 4% of deliverable supply in gold, for example. As exchange-set limits, NYSE Liffe U.S. has maintained these relatively conservative limits because it has the flexibility to adjust them as changing conditions demand.

NYSE Liffe U.S. is monitored real-time 22 hours a day, 5 days a week by dedicated market operations professionals who are trained to spot suspect behavior by market participants. In addition, we employ robust system safeguards to mitigate against the entering of bids and offers that are significantly in excess of existing market prices by market participants.

Policy Implications of Federally-Set Position Limits on Metals:

Over the years, position limits have been an effective mechanism for minimizing the potential threat of manipulation of a commodity, particularly in the delivery month. However, it is not clear that Federally-designed position limits for metals would have the desired effect of limiting unreasonable and abrupt price movements for these contracts just as Federally-set position limits for certain agricultural products did not appear to protect those products from price volatility during the recent commodity price bull run in 2008. See attached chart.

One of the clear lessons from the recent financial crisis is that the exchange-traded and cleared model for trading held up extraordinarily well as the over-the-counter markets faltered. This is due to the transparency that public exchanges provide to investors and regulators as well as the credit risk mitigation that clearinghouses offer. Rightfully so, there is a push by policy makers to either incentivize or mandate that more standardized OTC products come onto clearinghouses and exchanges. NYSE Euronext supports this need for reform of the OTC derivatives markets.

We also recognize that the crisis has led to calls for more regulation of on-exchange products, including the tightening of position limits. As I mentioned, rational position limits can help ensure an orderly market and fair pricing of listed contracts. However, there may be scenarios in which Federally-set position limits will work against the public interest and actually stifle competition in the futures industry.

The markets in which we operate are truly global in nature and as a result, actions by one government authority may have an affect on cross-border business. While position limits have been an effective regulatory tool over time in the U.S., there are other government authorities around the globe that prevent market congestion and manipulation through other means and do not require position limits in their regulatory regime.[1] Should the CFTC decide to design a position limits regime for the metals complex, it should be mindful that it does so in a way that does not force business into foreign jurisdictions or over-the-counter markets outside of U.S. regulatory oversight. This could cut against one of the clear lessons from the financial crisis.

In addition, if Federal position limits are determined to be necessary for the metals markets, the CFTC should design the regime not to solidify competitive advantages for currently dominant exchanges or hinder the migration of OTC business to a centrally-cleared exchange traded environment. Some have suggested that the CFTC take into consideration the relative size of a market when administering certain position limits.[2] For start-up exchanges like NYSE Liffe U.S., it would be difficult—if not impossible—to gain in market share against an existing exchange if position limits were administered in a manner that capped our growth potential.

In its January Federal Register release on Federal speculative position limits for energy contracts, the CFTC would allow markets seeking to list new covered energy contracts or compete with existing energy contracts an opportunity to succeed by establishing a minimum position limit level of 5,000 contracts or 1 percent of the aggregated open interest value, whichever is greater.[3] Should Federal position limits for metals be needed, such a mechanism must be in place to ensure that competition is not hindered by a cross-market position limit regime.[4]

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[1] See *Report of Financial Services Authority & HM Treasury, Reforming OTC Derivative Markets—A UK Perspective, December 2009*. Rather than impose position limits, the FSA utilizes a position management approach that requires UK exchanges to abide by position reporting requirements and requires exchanges to manage positions at any time throughout a contract's life cycle and to instruct a member to close or reduce a position with the exchange, if necessary, to secure fair and orderly markets. If the member does not comply, the exchange has the power to close the position unilaterally.

[2] On December 11, 2009, the House of Representatives passed the *Wall Street Reform and Consumer Protection Act, HR 4173*, which contains language for imposing position limits on U.S. linked contracts of foreign boards of trade requiring the CFTC to take into "consideration the relative size of the respective markets."

[3] Federal Register, Vol. 75, No. 16, Tuesday January 26, 2010; Notice of Proposed Rulemaking: Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations.

[4] There is precedent for such an idea. In April 1992, the Commission proposed amendments to the structure of Federal speculative limits in place for certain agricultural futures contracts. It proposed setting exchange-specific all months combined limits based on the level of open interest at each exchange. 57 Fed. Reg. 12766 (CFTC 1992). Both the Kansas City Board of Trade ("KCBT") and Minneapolis Grain Exchange ("MGE") objected that basing the limit on open interest was unwarranted and "put the smaller exchanges at an undue competitive disadvantage." 58 Fed. Reg. 17973, 17976 (CFTC 1992). In light of the criticism, the Commission reversed itself and adopted all

Rather than potentially harm competition, the CFTC should be thinking of ways to promote fair competition should it design a new position limit framework for metals. One could imagine designing a system where start-up exchanges receive an exemption from imposing a position limits regime—given the costs and burdens of building such a system—until a certain percentage of open interest is established relative to the total marketplace, inclusive of the existing OTC markets. From a policy perspective, this makes good sense because it is only when products become liquid that they begin to serve a significant price discovery function deserving of further regulation and protections.

Lastly, the Commission in developing these policies should be mindful of the unintended consequences outside of its markets caused by an overly restrictive position limit regime. While I speak today as head of our U.S. futures trading business, NYSE Euronext also has a significant exchange traded products (ETPs) business that will be impacted by position limit policies.

An exchange traded product (ETP) is an investment vehicle traded on regulated security exchange, much like cash securities. An ETP holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets over the course of the trading day. ETPs are attractive to investors because of their low costs, tax efficiency, and their ability to trade through-out the day compared with mutual funds. ETPs often track an equity index, like the S&P 500 or MSCI EAFE, but recent years have seen these instruments invest in other underlying assets, like commodities and notes.

The first precious metals-based ETP was the SPDR Gold Trust–first listed in November 2004. Today it is the largest exchange traded precious metals trust with $39.75 billion in assets. As of February 2010, there are now a total of 13 precious metals exchange traded trusts and 9 precious metal exchange traded notes (ETNs) listed on one of our securities exchanges—NYSE Arca—with total assets exceeding $50 billion.

U.S. gold exchange traded products assets are equivalent to 4 percent of global spot gold holdings according to the World Gold Council.[5] On the demand side of the equation, in 2009, all the global gold trust products represented 17 percent of the global gold demand[6] and for the first time surpassed the retail demand for gold bars and coins, which now represents 12 percent of global gold demand. For retail investors, this is welcome news as they now have greater access to these commodities through a regulated and transparent public marketplace rather than the less supervised and more opaque over-the-counter or spot-dealer markets.

We want to thank the CFTC for their efforts in entering into a memorandum of understanding in 2008 with the SEC that resulted in the approval of the options on SPDR Gold Trust. I can report that last month the consolidated average daily contract volume for this product was 225,000

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months combined position limits in wheat contracts traded on the KCBT and MGE at levels equivalent to the level the Commission set for the Chicago Board of Trade "[i]n light of the breadth and liquidity of the cash markets underlying the KCBT and the MGE wheat . . . contract." Id. at 17979.

[5] World Official Gold Holdings, World Gold Council, n.d Web March, 2010.

[6] Gold Demand Trends, World Gold Council, n.d. Web February, 2010.

contracts with an open interest of 4,500,000. This cooperation between the two Commissions has proven beneficial to the market and investors.

Part of the growth of ETPs can be attributed to their efficient structure. Nearly 98 percent of the precious metal trust's assets are represented by a trust holding spot bars as opposed to futures and swaps. The bars that the trusts hold are stored in safekeeping at bank vaults. The trusts are registered under the Securities Act of 1933 and the shares trade like any other exchange listed equity security.

Because of the efficiencies of these markets, the correlation of the ETPs to the price of the physical commodity is nearly one to one. The SPDR Gold Trust (GLD) has a narrow average spread of one basis point. The consolidated daily average notional turnover for all exchange traded gold trusts was $2.1 billion USD. This turnover—while noteworthy—only represents 10 percent of the total COMEX and NYSE Liffe U.S. gold contract average daily turnover in February, 2010. Similarly, the silver ETPs had a consolidated average daily turnover of $270 million USD in February, which represents only 5.75 percent of the total average U.S. Silver contract turnover. This is because the futures markets are an extremely efficient and liquid complement to these ETP markets for managing risks and arbitraging pricing anomalies.

While future contracts are not directly held by the trusts that hold the physical spot commodities, the ETP market makers do utilize the futures markets intraday to hedge their exposure. Potential futures position limits could restrict how traders manage risk against the spot metal ETPs, which could lead to wider spreads and a reduction in displayed liquidity for investors. Institutions that have separate commodity trading and ETP market making operations are also at risk of being impacted by potential firm-wide position limits because it will become more difficult for the ETP market makers to manage their exposures using futures contracts.

While rational position limits—as we impose and administer today—are needed to protect against manipulation and excessive market concentration, the Commission should be mindful that Federally-set position limits will have an impact on other markets that use futures contracts to either discover prices or manage risk for precious metal commodities without necessarily dampening the price volatility for these commodities.

In closing, I appreciate the Commission providing NYSE Liffe U.S. with an opportunity to testify today. Fair competition in these markets is—not only an explicit part of the CFTC's mission—but furthers the public interest by providing market participants with greater investment choices at lower costs. As new entrant in these markets, NYSE Liffe U.S. is committed to the derivatives marketplace and eager to compete for the benefit of investors and consumers. Thank you for allowing me to testify.

Percentage Annual Price Changes for Commodities
April 2007 through April 2008
Data from CFTC Agricultural Roundtable, April 22, 2008

COMMODITY	PRICE CHANGE
Rice	122 %
Wheat (KCBT)	99 %
Wheat (CBOT)	95 %
Soyoil	88 %
Soybeans	83 %
Crude Oil (NYMEX)	82 %
Soymeal	73 %
Corn	66 %
Cotton	48 %
Oats	47 %
Gasoline	41 %
Cocoa	37 %
Gold	37 %
Sugar (#11)	30 %
Coffee	24 %
Producer Price Index	7 %
Milk	5 %
Lean Hogs	-5 %
Feeder Cattle	-7 %
Live Cattle	-7 %
Lumber	-14 %

= Currently Subject to Federal Position Limits