



Commodity Futures Trading Commission

Office of External Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Testimony

Testimony of Terry S. Arbit General Counsel

Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets September 18, 2007

Introduction

Good morning. My name is Terry Arbit and I am General Counsel of the Commodity Futures Trading Commission. I have been asked to help frame the discussions at today's hearing by providing an overview of the statutory structure for derivatives markets established under the Commodity Exchange Act (the CEA), and describing how Exempt Commercial Markets fit into that structure. Along the way, I will identify some common misperceptions regarding the legal environment in which Exempt Commercial Markets currently operate.

CEA's Multi-Tiered Market Structure

In the Commodity Futures Modernization Act of 2000 (or CFMA), Congress established a tiered approach to regulatory oversight of derivatives markets. Each tier is subject to a varying level of oversight, based primarily on the commodity traded, the type of trading, and the nature of the participants in the market.

Among futures markets, the designated contract market occupies the top tier, representing what is often described as a "fully regulated" futures exchange. A contract market may trade contracts based on any commodity, and may offer products to retail customers on an unrestricted basis. Under the CFMA's principles-based oversight regime, contract markets are afforded significant flexibility in how they run their operations, but nonetheless must initially satisfy specified designation criteria, and thereafter must demonstrate compliance with comprehensive core principles on an ongoing basis.

The CFMA also created a new category of futures exchange, called a derivatives transaction execution facility (or DTEF). There are two types of DTEF, a retail DTEF and a commercial DTEF. Both DTEF categories have fewer regulatory requirements than a contract market, but are subject to differing limitations on eligible traders and the commodities that may be traded. Although subject to a “lighter” regulatory regime, this alternative exchange must have compliance and surveillance programs, and must undertake significant self-regulatory responsibilities. These include a requirement to establish and enforce rules to deter trading abuses and to monitor trading to ensure orderly trading. To date, no trading facility has applied to the Commission to register as a DTEF.

The CFMA also created a broad – and complex - array of exclusions and exemptions from regulation for certain derivatives products that are traded over-the-counter, either bilaterally or on electronic trading facilities. These exclusions and exemptions reflect the view, consistent with various Congressional and Commission actions during the preceding decade, that off-exchange transactions between sophisticated counterparties do not necessarily require the full weight of the protections that the CEA provides for contract markets and DTEFs.

One such exemption, which we are gathered to discuss here today, is for transactions in exempt commodities on electronic trading facilities that are known as Exempt Commercial Markets. Exempt commodities include commodities such as energy, metals, chemicals, and emission allowances.

It is sometimes said that Exempt Commercial Markets are unregulated. But this is not quite right. Although largely exempt from Commission oversight authority under the CEA, Congress did subject Exempt Commercial Markets to a limited set of regulatory requirements under Sections 2(h)(3) through (5) of the statute. The Commission has implemented these requirements in its Rule 36.3.

In recent years, derivatives trading on certain Exempt Commercial Markets has grown substantially, due in no small measure to the regulatory environment created by the CFMA. At the same time, Exempt Commercial Markets have evolved in ways that may not have been anticipated when the CFMA was enacted. The question arises, therefore, whether the regulatory line for Exempt Commercial Markets that was drawn by Congress in the CFMA remains appropriate today. That is, on the regulatory spectrum ranging from no regulation of bilateral over-the-counter transactions on the one hand, to fully-regulated futures exchanges on the other hand, should policy-makers adjust the line governing Exempt Commercial Markets further along the spectrum toward the degree of regulation applicable to contract markets and DTEFs?

With that background, let me now discuss how Exempt Commercial Markets are regulated under the CEA, in four areas: 1) first, market participants; 2) second, regulatory requirements; 3) third, differences between Exempt Commercial Markets and contract markets; and 4) finally, the Commission’s anti-fraud authority over Exempt Commercial Markets.

Exempt Commercial Markets

1. Market Participants on Exempt Commercial Markets

Exempt Commercial Markets are electronic trading facilities that restrict trading to principal-to-principal transactions between “eligible commercial entities.” The term “eligible commercial

entities,” like the name “Exempt Commercial Markets,” connotes a purely commercial marketplace among entities that can make or take delivery of the underlying commodity. But that also is not quite right. Under the statutory definitions of the CFMA, pooled investment vehicles such as hedge funds qualify as “eligible commercial entities,” and their participation on certain Exempt Commercial Markets has become both active and significant.

2. Regulatory Requirements for Exempt Commercial Markets

Exempt Commercial Markets are subject to certain recordkeeping and reporting requirements under the CEA. The CEA requires that an Exempt Commercial Market must maintain for five years, and make available for inspection upon request by the Commission, records of its activities related to its business as a trading facility. More specifically, under Rule 36.3, an Exempt Commercial Market must identify to the Commission those transactions which averaged five trades per day or more over the most recent calendar quarter. For all such transactions, the Exempt Commercial Market must provide to the Commission weekly reports showing certain basic trading information, or provide the Commission with electronic access that would allow the Commission to compile the same information.

The CEA also gives the Commission the authority to require an Exempt Commercial Market to provide, upon special call, information relating to its business as the Commission may determine appropriate to enforce the anti-fraud and anti-manipulation provisions of the CEA, to evaluate a systemic market event, or to obtain information on behalf of another federal financial regulator. Commission staff has issued several special calls to the InterContinental Exchange, an Exempt Commercial Market generally referred to as “ICE,” requesting information on trader positions in ICE natural gas contracts that are directly linked to NYMEX futures prices. The purpose of these special calls was not to surveil ICE, as the Commission has no statutory authority to do so. Rather, these special calls were issued to support surveillance of the NYMEX natural gas contracts.

The Commission has imposed one further recordkeeping requirement on Exempt Commercial Markets in its Rule 36.3. That rule requires an Exempt Commercial Market to maintain a record of allegations or complaints that it receives concerning suspected fraud or manipulation, and to provide the Commission with a copy of the record of each complaint that alleges facts that would constitute a violation of the CEA or Commission regulations.

3. Differences between Exempt Commercial Markets and Contract Markets

Though Exempt Commercial Markets are subject to these limited regulatory requirements, the CEA does not subject them to the level of transparency and Commission oversight associated with contract markets. Contract markets must satisfy specified criteria to become designated, and then demonstrate compliance with core principles on a continuing basis. These core principles require regulated futures exchanges to undertake significant supervisory responsibility with respect to trading on their markets. For example, contract markets may trade only those contracts that are not readily susceptible to manipulation, and must have rules and procedures for preventing market manipulation. Furthermore, contract markets are required to adopt position limit or accountability rules in order to address the potential for market manipulation or congestion. Contract markets must have compliance and surveillance programs, which the Commission evaluates through its rule enforcement reviews.

These statutory requirements, however, do not apply to Exempt Commercial Markets. An Exempt Commercial Market is not required to monitor trading on its facility. Nor does the Commission have the same authorities to address problems on Exempt Commercial Markets as it does for contract markets. For example, the Commission's statutory emergency authority, and its authority to force a reduction or liquidation of positions and to alter or supplement a trading facility's rules, where appropriate, do not extend to Exempt Commercial Markets.

The CEA does provide that the Commission may determine that an Exempt Commercial Market performs a significant price discovery function for transactions in an underlying cash market. Such a determination does not trigger additional self-regulatory responsibilities or additional oversight authority for the Commission. Rather, it triggers an obligation by the Exempt Commercial Market to publicly disseminate certain specified information such as contract terms and conditions, trading volume, open interest, and opening and closing prices or price ranges.

4. Commission Anti-Fraud Authority over Exempt Commercial Markets

Exempt Commercial Markets are subject to the CEA's anti-fraud and anti-manipulation provisions. In November 2000, the Seventh Circuit Court of Appeals suggested in the *CTS* case that Section 4b of the CEA, the Commission's primary anti-fraud tool, is limited to intermediated transactions—that is, those involving a broker.¹ As part of its ongoing Reauthorization process in Congress, the Commission has proposed an amendment to Section 4b, the terms of which have been agreed to by the various sectors of the futures industry. This important legislative amendment would clarify the Commission's authority to bring fraud actions involving principal-to-principal transactions that occur on Exempt Commercial Markets.

Conclusion

Now, with this summary of the statutory structure for derivatives markets in mind, let me turn it over to my colleagues for a discussion of the Commission's work with respect to Exempt Commercial Markets in practice.

¹ *Commodity Trend Service, Inc. v. CFTC*, 233 F.3d 981, 991-992 (7th Cir. 2000).