



**Commodity Futures Trading Commission**

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# Testimony

**Testimony of Rick Shilts  
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**Hearing to Examine Trading on Regulated Exchanges  
and Exempt Commercial Markets  
September 18, 2007**

## **Introduction**

Good morning, my name is Rick Shilts and I am director of the Commission's Division of Market Oversight. The division's primary mission involves oversight and surveillance of activity on the regulated futures exchanges, called contract markets or DCMs. The division also carries out the requirements of the law related to Exempt Commercial Markets or ECMs.

## **Background on ECMs That Have Filed Notice**

I would like to start by providing some background information on the ECMs that have filed a notice to date. As was described by our General Counsel, the ECM category was created by the CFMA in December 2000. Two of the first facilities to file notices in 2001 were the International Maritime Exchange or Imarex, a Norwegian market, and the Intercontinental Exchange located in Atlanta, also known as ICE.

From 2001 to now, a total of 20 companies have filed notifications to operate as an exempt commercial market. Just in the past year, we received 3 new ECM filings. In addition, our staff currently is in contact with several other companies who are actively contemplating filing formal notifications.

Not all ECMs are successful. Currently, only eight of the 20 ECMs that have filed a notice are active. The others have gone out of business or have been acquired by another ECM; some have not yet commenced operations.

Of the 20 ECMs filing a notice, many trade, or plan to trade, energy-related products -- mostly natural gas, petroleum products and electricity. Other commodities that have been listed, or intended, for trading on ECMs include emission allowances, metals, freight rates, chemicals, uranium, fertilizers, pulp and paper products and liquefied petroleum gas.

The largest ECM, in terms of trading volume and number of contracts traded, is the Intercontinental Exchange, which as I noted was one of the first ECMs to file a notification. ICE operates an ECM as well as regulated futures exchanges in the U.S. and the UK. The principal contracts listed on ICE's ECM are in the energy area, especially natural gas and electricity, and, since acquiring ChemConnect in July of this year, another active ECM, natural gas liquids and chemicals.

Other active ECMs include the Natural Gas Exchange, Inc. (or NGX), NetThruPut, HoustonStreet Exchange, Imarex, the Chicago Climate Exchange, ICAP Electronic Trading Community, and ICAP Commodity and Commodity Derivatives Trading System.

Five of the eight active ECMs offer clearing services, including ICE. Formerly, ECMs did not offer a clearing component initially; they generally did not provide a clearing service until they reached some level of success or threshold level of activity. This approach seems to have changed recently, as newer ECMs contemplate offering clearing at start up. In this regard, three of the ECMs filing a notice in the past year indicated a plan to offer clearing services initially.

In discussions with new ECMs, our understanding is that the reduced regulatory burden, compared to contract markets and DTEFs, is a key reason why companies choose to operate in this regulatory tier. They view the reduced regulatory burden as being more consistent with their business operations and goals. In this regard, for many ECM's, the majority of their business comes from non-regulated OTC world including institutional traders. Becoming an ECM allowed them to expand into electronic trading under a relatively less formal and demanding regulatory scheme. For many, it does not appear that the ECM route is viewed as a first step into eventually becoming a regulated exchange.

## **Evolution of ECMs**

I would like to offer a few observations regarding the evolution of ECMs since the CFMA was adopted. Initially, ECMs generally were bare bones trading platforms. In many ways, they were akin to business-to-business facilities for large commercial firms. Their key role was to facilitate the execution of trades between commercial counterparties, by offering an anonymous and efficient electronic matching system. The ECMs believed that their electronic systems were superior to the existing voice broker system and gave them a competitive advantage in the bilateral OTC market, especially in the energy space.

The first ECMs did not offer a clearing component -- they addressed issues related to the financial integrity of transactions by setting up credit filters that allowed traders to limit their counterparties to a customized list of traders. In addition, ECM participants were primarily commercial traders, and most ECMs were start-ups or relatively small operations. Initially, ECM trading volumes were small relative to volumes on the regulated futures exchanges. Finally, early ECM contracts were generally not directly linked to regulated futures markets and did not affect the Commission's oversight of activity on the regulated exchanges.

In recent years, we have witnessed a number of changes in the ECM landscape. Today, while there continue to be small ECMs – many of which are start-up ventures – we also see some ECMs that have taken on many of the characteristics of regulated futures exchanges. These ECMs are not just a forum for efficient trade execution; they now offer other benefits and features in response to the needs and demands of their participant traders.

A significant change is that some of the most successful ECMs now offer a clearing component that has been widely utilized by their participants as an efficient and effective way to manage credit risk. In addition, some ECMs have become major trading venues for particular commodities, especially for natural gas and electricity.

There also have been changes in the types of traders that participate on ECMs. In this regard, certain exchange floor brokers and floor traders now are considered Eligible Commercial Entities (or ECEs) and thus they can participate on ECMs. Also, the trading community on ECMs now includes many non-commercial traders, such as large hedge funds, which constitute a significant part of the overall activity and open interest in certain ECM contracts.

Another consideration is that some of the ECMs link their contracts to the prices of related contracts on the regulated contract markets. This feature has created certain complications for CFTC staff in carrying out the Commission’s mandate to oversee the regulated markets. Of special concern is that the existence of cash-settled “look-alike” contracts that could provide an incentive to manipulate the settlement price of the underlying regulated contract market price in order to benefit from positions in the “look-alike” ECM contract.

In view of these developments, certain large ECMs now seem to resemble the regulated futures exchanges with respect to certain products traded thereon. For example, with respect to these actively traded, cleared products:

- Both the regulated exchanges and the large ECMs provide a forum for traders to execute transactions on a many-to-many, multilateral platform;
- For both markets, the same types of traders are active participants;
- They both employ the same types of cash settlement features;
- Both offer a clearing function as an effective way to manage counterparty risk;
- Finally, certain of the derivatives products offered by regulated contract markets and ECMs provide the same economic benefits – that is, risk management or serving as a source of price discovery for industry participants.

Recognizing these similarities, there have even been indications that some ECMs might be willing to accept a certain level of heightened CFTC oversight with respect to certain types of products. In addition, we understand that the physical commodities markets have been a topic of interest in other jurisdictions. For example, the European Commission (EC) is considering whether to maintain an exemption from various reporting and prudential requirements for certain commodities traders, including large energy companies. The EC recently conducted a survey on the issue and reported that certain regulatory authority may be appropriate.

### **CFTC Oversight & Ongoing ECM Requirements**

As Terry discussed, under the Commodity Exchange Act, Commission staff does not directly surveil or monitor trading activity on ECMs on an ongoing basis as it does for contract markets.

As he also noted, the CEA sets forth several basic oversight provisions applicable to ECMs, including a price discovery provision.

I want to talk a little more about the price discovery requirement. Specifically, the law provides that ECMs shall disseminate price, trading volume and other trading data if the Commission determines that the ECM performs a significant price discovery function for transactions in the cash market. This provision is contract specific and, if triggered, requires dissemination of data with respect to the particular contract that has been found to perform a price discovery function.

In 2004, the Commission issued regulations stating what constitutes being a price discovery market for this purpose. Specifically, under our regulations, an ECM contract is a price discovery market if

- 1) cash market bids, offers, or transactions are directly based on, or quoted at a differential to, the prices generated on the market on a more than occasional basis, or
- 2) the market's prices are routinely disseminated in a widely distributed industry publication and are routinely consulted by industry participants in pricing cash market transactions.

It should be noted that the statutory price discovery provision is somewhat circular. In this regard, the statute mandates dissemination of trading data if an ECM performs a significant price discovery function for the underlying cash market, but the underlying cash market could not be relying on the ECM contract for price discovery unless such data were already being disseminated in some form. The Commission acknowledged the apparent circularity of the test in the price discovery criterion but noted that its rules will ensure that the trading data is disseminated as Congress intended.

### **Staff Observations as to Whether ICE Performs a Price Discovery Function**

The Commission has not, under its rules, issued a formal price discovery determination with respect to any ECM contracts. However, in connection with this Hearing, our staff conducted a series of interviews with market participants to learn more as to how they trade natural gas and electricity and whether ICE prices are used a basis for price discovery for natural gas and electricity. I should note that price discovery is not a defined term in the CEA or in the economics profession and the term may mean different things to different people. Our chief economist will talk more about this in a few minutes.

Most traders and voice brokers expressed the view that ICE is a price discovery market for certain natural gas and electricity contracts. For example, with respect to the Henry Hub natural gas market, market participants generally view ICE and NYMEX as essentially a single market. Traders look to both ICE and NYMEX when determining where to execute a trade at the best price. They stated that both marketplaces offer liquid and financially secure contracts. Traders take positions in a NYMEX physically-delivered or cash-settled contract or in an ICE look-alike swap depending on where they can get the best price.

For natural gas trades at locations other than the Henry Hub, market participants told us that ICE prices are widely consulted by the industry, especially for contracts involving gas at certain specific locations in the Western U.S. For certain electricity markets, traders indicated that ICE

prices and indexes are widely consulted before executing a trade. ICE prices are consulted more regularly than NYMEX which has not gained significant volume in the electricity space.

As noted, Commission regulations provide that an ECM contract is a price discovery market if cash trades are directly based on the ECM's prices or if its prices are disseminated in industry publication and routinely consulted by industry. While market participants generally have expressed the view that ICE prices are widely consulted and utilized by the industry for many natural gas and electricity markets, we have not yet concluded that ICE natural gas or electricity contracts meet all the specific requirements outlined in the Commission's price discovery regulations. Our staff continues to gather more information about this issue.

I should further note that staff is reconsidering whether the Commission's price discovery criteria remain appropriate. For example, since adopting the price discovery regulations, some ECM contracts that are linked to the prices of a regulated futures market have developed significant open interest and commercial participation. Since this feature was not previously contemplated, the Commission may wish to consider other market characteristics that would cause an ECM contract to be classified as a source of price discovery market for the cash market. As mentioned, our discussions with industry participants indicate that traders regularly consult ICE prices in making trading decisions, and that they view ICE and NYMEX as essentially one market for Henry Hub natural gas futures, with price formation occurring in both markets. It appears that, when two markets are linked in this way, both markets may constitute the price discovery market for the commodity in question, as it is difficult, if not impossible, to split the two and assign the price discovery role to a single market. Recognizing this, it may be appropriate for the Commission to reconsider its price discovery criteria to include an additional standard for linked markets.

That concludes my remarks. I will now turn it over to our chief economist, who will discuss the work of his office on the issue of price discovery.