



Commodity Futures Trading Commission

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Testimony

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**Hearing to Examine Trading on Regulated Exchanges
and Exempt Commercial Markets
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Introduction

Good morning. My name is John Fenton and I am director of the Commission's Market Surveillance Program. This program's primary mission is to deter and prevent price manipulation or any other disruptions to market integrity on regulated futures exchanges (DCMs). I am pleased to have this opportunity to talk a bit about how we do surveillance on futures markets, and, in particular, what we have been doing in energy futures markets.

Manipulation Defined

While the Commodity Exchange Act prohibits manipulation, it does not specifically define it. This omission is a recognition by Congress that a precise definition would almost certainly fail to capture the complexity and variety of potential manipulative behavior. It has been through the development of case law under the Commodity Exchange Act that the elements of a definition of manipulation have emerged. At the risk of oversimplifying, I think a general definition of manipulation is that it is any market behavior that is intended to cause, and that succeeds in causing, an artificial price. Of course, this raises the question what is an artificial price? An artificial price is a price that does not accurately reflect the legitimate market forces of supply and demand. In other words, it is a price that is an artifice intentionally created by the manipulator, that otherwise would not exist. Although the elements of manipulation have emerged through cases brought by our Division of Enforcement, they are also extremely relevant for how we conduct surveillance to deter and prevent manipulation. For example, the ability to cause a manipulation may stem from a dominant futures position, and, as I will describe more fully in a few minutes, to counter this potential threat we monitor futures market positions on a daily basis.

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Before proceeding I should mention that my comments are specifically related to the scope of the Commission's market surveillance program to deter and prevent manipulation on designated contract markets, those markets described in Terry Arbit's testimony as "fully regulated" exchanges. The Commission's authority to bring anti-manipulation enforcement actions clearly extends more broadly than this, to include, for example, manipulative activity in cash markets and on exempt commercial markets.

Two Types of Futures Contracts and Their Vulnerability to Manipulation

Futures contracts are of two general types depending on how they are ultimately settled—either through physical delivery or through cash settlement. In both cases, the settlement mechanism is meant to ensure that at expiration the futures price converges to the cash value of the underlying commodity. The pricing integrity of a futures contract—its efficiency as a price discovery and as a risk management tool—depends upon the expectation that at expiration its price will reliably represent the legitimate supply and demand factors affecting the underlying commodity. The overwhelming success of futures markets proves that this is usually the case. In futures markets settled through physical delivery, traders can normally arbitrage between futures and cash to ensure convergence. If futures prices seem too high relative to cash prices, there will be relatively greater interest in making delivery, tending to cause futures prices to fall. If futures prices seem too low, the opposite will occur. In cash-settled futures markets, the final settlement price will necessarily represent the value of the settlement index at expiration.

However, these settlement mechanisms are potentially vulnerable to attempts at price manipulation. In futures markets settled through physical delivery, manipulation or attempted manipulation is likely to involve the use of market power to dominate the delivery process. For example, a market squeeze would involve a trader holding a dominant long position, in excess of the supply available for delivery on the contract. The long trader could use that dominance to extract artificial prices from traders holding short positions who could not make delivery and would be forced to buy back their positions versus the dominant long trader. To protect against this type of manipulation, our market surveillance program has two main tools: large-trader position reporting and spot month position limits. I will discuss our large trader reporting system in more detail in a few minutes, but the point I would like to make now is that large trader reporting allows us to monitor the size of positions very carefully to detect a possible impending squeeze. In addition, spot month position limits mitigate against manipulation by restricting the size of positions as a contract approaches expiration, the period when it is vulnerable to being squeezed. Historically, the Commission has used as a guideline that exchanges set spot month position limits at a level no greater than 25 percent of the normal deliverable supply. The current spot month position limit for the NYMEX Henry Hub natural gas futures contract is 1,000 contracts.

Manipulation of a cash-settled futures market occurs more indirectly. Since a cash-settled futures market references some other price for its final settlement, a manipulative scheme would involve manipulation of that reference price. In such a scheme, large positions in a cash-settled futures contract would provide the motive for a manipulation, but the manipulative activity would occur in the market for the reference price. Such a scheme might involve relatively heavy buying in the market used as a price reference to force that price to an artificially high level, which would then be used to cash settle a much larger long position in the cash-settled futures market. The formula for detecting this type of manipulative activity is close scrutiny of prices

and trading activity in the reference market, along with large trader information about positions that are cash-settled using that reference price.

Focus of Commission Surveillance of Energy Markets

The focus of the Commission's surveillance of energy markets has been on the regulated futures markets at NYMEX. At least three reasons explain this focus: (1) this is the mandate provided by Congress in the Commodity Futures Modernization Act of 2000, (2) the NYMEX Henry Hub final settlement price has played a unique role as the central reference price around which other cash, futures, and OTC derivative prices have revolved, and (3) this reflects the reality of limited Commission resources. While each of these reasons still holds, it has become increasingly apparent that proper surveillance of the regulated markets at NYMEX requires increased regulatory transparency into trading activity of cleared products linked to NYMEX. With that in mind, I would like to briefly describe some of the key pieces of information that we receive for regulated futures markets, such as NYMEX, and three special calls issued to ICE to obtain similar information.

Information Received From DCMs

Pursuant to part 16 of the Commission's regulations, DCMs are required to provide daily data showing aggregate positions and trading cleared by each clearing member, shown separately for house and customer positions. This data includes all positions in futures markets at DCM, but it does not provide information on the size and identity of customer positions.

The centerpiece of the Commission's market surveillance program is its large-trader reporting system ("LTRS"). Under the LTRS, clearing members, futures commission merchants, and foreign brokers—collectively called "reporting firms"—file daily reports with the CFTC showing futures and options positions held in accounts they carry that are at or above specific reporting levels set by the CFTC. These reporting levels vary by market, from as low as 25 contracts for small markets to as high as 3,000 contracts for the largest market, the Eurodollar futures market at the Chicago Mercantile Exchange. The reporting level for natural gas futures markets is 200 contracts. The data provided in these reports in aggregate has covered about 97% of total open interest in the NYMEX Henry Hub natural gas contract during the past year.

The Commission also receives large-trader reporting for contracts that are cleared through NYMEX's Clearport facility. Typically, these transactions initially occur in the OTC market, through voice brokers, and are then submitted to Clearport for clearing. In interviews with industry participants, staff has heard that contracts cleared through Clearport represent a significant portion of the OTC activity conducted through voice brokers.

In addition to large trader reporting for NYMEX markets, the Commission receives from NYMEX daily transaction data. This provides a complete audit trail of all trades that occur in NYMEX markets. Surveillance staff use this data to closely scrutinize trading activity during key trading periods, especially during the closing range of the final trading day.

Special Calls to the Intercontinental Exchange

The Division of Market Oversight has issued three special calls to the Intercontinental Exchange for information related to ICE's cleared natural gas swap contracts that are cash-settled based on

NYMEX physical delivery natural gas contract. In each case, the information requested has been analogous to information that the CFTC receives from DCMs, including NYMEX. The first special call was issued on September 28, 2006, requesting daily clearing member position data, broken out between house and aggregate customer positions. This is similar to information that the Commission receives from DCMs under part 16 of the Commission's regulations. The Commission has been receiving responsive data from ICE since October 10, 2006. With this data, market surveillance staff can see all cleared positions at the clearing member level, but it is not possible to determine individual customer positions from this data.

To address this gap, the Commission issued a second special call on December 1, 2006 to obtain daily individual trader positions. The Commission has been receiving responsive data since February 15, 2007. While the content of this data is similar to large trader reporting for DCMs, the methodology for reporting is very different. Large trader reporting for products traded on DCMs is not done by the exchanges, but by the carrying firms, generally futures commission merchants for U.S. traders, and foreign brokers for non-U.S. traders. Since the reporting firms know directly these positions, this reporting is fairly straight-forward and highly accurate. The Commission's authority to issue special calls with respect to trading and positions on ECMs is limited to the ECM itself. ICE was not, and is not, receiving position reporting from firms. Therefore, in order to comply with the Commission's special call, ICE has developed an algorithm to infer open positions from the sum of all trading by each individual trading firm. While this approach is innovative and has provided very valuable information to the Commission, it is not yet as accurate as traditional large trader reporting. Commission staff continue to work with ICE to improve the accuracy of this data. ICE is providing this information in the standard electronic format used for Commission large trader reporting, which has allowed us to relatively easily integrate this data into our computer surveillance systems and to examine traders' consolidated positions on NYMEX and ICE.

I would like to make two observations with respect to insights afforded by large trader reporting for NYMEX and ICE natural gas products. The first point is that the composition of commercial and non-commercial activity in these two markets, as measure by open positions, is actually quite similar. On a recent date, non-commercial traders held about 46 percent of open long positions and 52 percent of open short positions in NYMEX's Henry Hub physical delivery futures contract. On that same date, non-commercials held about 46 percent of open long positions and 36 percent of open short positions in ICE's linked Henry Hub swap contract. This highlights that there is a substantial overlap of traders in these two markets. The second observation is based on Commission staff interviews of industry participants in anticipation of today's hearing. When asked how much of the total trading activity involving Henry Hub futures and swaps that the Commission was seeing as a result of large trader reporting of cleared positions on NYMEX, Clearport, and ICE, the unanimous response was that we were seeing the vast majority of all such positions.

The most recent special call to ICE was issued on September 5, 2007. This special call requires ICE to provide all cleared transaction data for their Henry Hub swap contracts, identifying counterparties, for the final two trading sessions prior to the expiration of prompt month Henry Hub natural gas products. This data is similar to transaction data that the Commission receives from NYMEX for all trading days. When the Commission begins to receive this data, we will be able to monitor trading activity on ICE during these crucial last two days, in conjunction with our analysis of NYMEX trading, to provide more complete coverage to counter possible manipulative schemes.

Conclusion

Thank you for this opportunity to briefly describe the Commission market surveillance program for energy futures markets. This concludes my presentation.