Management's Discussion and Analysis

Inspector General's FY 2006 Assessment

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TO: Reuben Jeffery III
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FROM: A. Roy Lavik ARL
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SUBJECT: Inspector General's Assessment Of The Most Serious Management Challenges Facing CFTC.

On January 24, 2000, Congress enacted the *Reports Consolidation Act of 2000* to provide financial and performance information in a more meaningful and useful format for Congress, the President, and the public. Included in the Act is the requirement that the Inspector General of each federal agency summarize what he or she considers to be the most serious management and performance challenges facing the agency and assess the agency's progress in addressing those challenges. In accordance with the *Reports Consolidation Act of 2000,* we are submitting an annual assessment of the major management challenges confronting the Commodity Futures Trading Commission (CFTC).

Congress left the determination and threshold of what constitutes a most serious challenge to the discretion of the Inspector General. As a result, we applied the following definition in preparing this statement:

> Serious management challenges are mission critical areas or programs that have the potential for a perennial weakness or vulnerability that, without substantial management attention, would seriously impact agency operations or strategic goals.

In Fiscal Year 2002, Congress passed the Accountability of Tax Dollars Act. This Act requires CFTC, along with numerous other federal entities, to have its financial statements audited annually. On January 15, 2004, the Office of the Inspector General (OIG) hired an independent public accounting firm, KPMG LLP, to conduct an audit of the CFTC's financial statements. Since then, KPMG LLP at our request, has annually conducted an audit of the CFTC's financial statements and rendered an opinion on the statements. I am pleased to say that, for fiscal year 2006, the financial statement audit resulted in an unqualified audit opinion. This letter relied on the data contained in the audited financial statements as well as the agency's Performance and Accountability Report (PAR).

SERIOUS MANAGEMENT CHALLENGES

The OIG reviewed all the management challenges listed by program areas as well as external challenges mentioned in the PAR. As a result of our review, the OIG concludes that management fairly stated the challenges faced by the agency and identified in the PAR. Nonetheless, the OIG identifies two management challenges that we consider to be the most serious challenges facing the agency. Although the PAR identified challenges by program areas, the OIG adopted a broader, agency-wide perspective in selecting two management challenges.

We acknowledge the significant accomplishments listed in the PAR generated by the historically low full-time-equivalent staff (approximately 462 FTEs) employed at the agency during this recent fiscal year. As mentioned in the OIG's management challenges of last year, we expressed our concern about

> *How the agency handles unanticipated events such as market disruptions and FCM bankruptcies will be closely watched by a worldwide audience.*

During the recent fiscal year the agency was able to successfully handle three major market events: the Refco LLC. case, MotherRock LP case, and the Amaranth Advisors LLC. case. Consequently, we are encouraged that the agency appears to have established appropriate procedures for these types of market events and proactively strengthened agency policies that foster customer and market protection objectives.

However, in the present instance, based on our familiarity with the agency and our review of current industry trends, we have identified the following potential management challenges faced by the agency. Industry Consolidations and Exchange Trading Revolutions will stress the regulatory resolve of the CFTC in allocating its staff to its market oversight mission mandated by Congress.

Industry Consolidations

Recently, the two largest floor based derivatives exchanges have agreed to merge. This consolidation wave in the derivatives industry will likely continue and combined with the trend towards demutualization in ownership result in fewer non-publicly traded exchanges. Consequently, the CFTC will have to evaluate its decisions and actions relative to other regulatory agencies such as the SEC and others (exchange shareholders, non-U.S. regulators and other stakeholders) that are now directly affected by actions undertaken by the CFTC affecting the consolidated entity. Active consultation with members of the President's Working Group on Financial Markets will be essential in order to effectively address any unanticipated market disruptions.

Exchange Trading Revolutions

The passage of the Commodity Futures Modernization Act on December 15, 2000 fundamentally changed the role of the CFTC from a prescriptive regulator to more of a principles based regulator. Since then the sheer volume of on exchange trading of derivatives has grown dramatically to over 2 billion derivative contracts traded annually on U.S. based exchanges.

Along with this tremendous growth in trading volume we have witnessed structural changes in the industry that challenge the flexibility and resourcefulness of the regulatory paradigm ushered in by the CFMA. Recently the agency has responded to these changes by expanding its views on best practices issues such as corporate governance which may foster greater responsiveness to exchange stakeholders.

Further the agency has historically relied on floor based surveillance of derivatives markets which now are rapidly dwindling in trading volume prominence. Currently over sixty percent of exchange traded derivatives are conducted on an electronic platform. This raises the question of whether the agency has the information technology infrastructure and staff to efficiently and effectively conduct timely surveillance of these dynamic and economically essential global markets.

These aforementioned challenges will be magnified should the agency fail to secure sufficient budgetary resources to mitigate its nearly twelve month old hiring freeze. Nonetheless, we are encouraged that the agency has judiciously allocated its budgetary resources to the three goals stated in the PAR. We are optimistic that the two key management challenges that we have identified can be managed by the agency in the near future. We look forward to contributing in identifying inefficiencies that can be avoided so that the agency will continue to wisely allocate its resources to meet its congressionally mandated mission.

When necessary, the OIG has worked with the Government Accountability Office to examine aspects of the agency's operations that members of Congress have expressed a particular interest in understanding, such as the agency's handling of Civil Monetary Penalties, its surveillance of the energy markets and review of hedge funds. The OIG will continue to provide an independent and constructive review of agency operations so that the agency can continue to improve its performance in maintaining the integrity and usefulness of the products offered by the futures industry.

The OIG takes its mission and authority seriously and remain committed to promote integrity, accountability, and transparency at this agency.

Management Addresses Inspector General's FY 2005 Assessment

In the FY 2005 Performance and Accountability Report, the Inspector General identified two "serious management challenges" facing the Commission: 1) Human Resource Planning, and 2) Challenges in the Marketplace.

The following is the Inspector General's FY 2005 assessment for each challenge and the Commission's actions taken in FY 2006 to address these challenges.

Challenge #1, Human Resource Planning

FY 2005 IG Assessment:

"Last year, we highlighted the forthcoming human resource challenge likely to be faced by the agency in FY 2006. This year that challenge is ever more apparent. By March 2006, current estimates are that over 20 percent of CFTC staff including 28 percent of the agency's leadership positions will be eligible for retirement. Consequently, based on these factors, this is a significant challenge faced by a relatively small Federal agency which will necessitate careful planning by management. The OIG is heartened by the agency's decision to establish a Human Capital Team to catalogue current skills of existing employees and propose possible pathways for meeting this potential deficit that is likely to occur in the next six months. We look forward to the agency successfully accommodating the approaching wave of employee retirements without materially disrupting the performance of the agency."

FY 2006 Actions Taken or Actions in Progress:

- To assure high-level attention to human capital planning issues on an ongoing basis, agency leadership directed the formation of the Pay Parity Governance Committee (PPGC), in March 2006. The PPGC is a permanent body with rotating membership from all offices, divisions, and regions and is charged with identifying, studying, and recommending solutions to agency human resources challenges, particularly those that may be positively affected by pay parity. It focuses on effective use of the agency's authority to seek total compensation parity with the other Federal financial regulators, as provided by the 2002 amendments to the CEA, in support of attracting, retaining, and developing agency talent. The Office of Human Resources (OHR) provides two technical representatives to support committee research and communications. By meeting weekly since March of 2006, the PPGC has made significant progress by completing its initial project to prepare a compensation philosophy that will guide future pay parity program choices and to update the agency performance management system so it can support the move to a modern pay-for-performance system. These initiatives will provide the requisite foundation of an improved ability to account for and reward results, which will in turn support effective implementation of programs to strategically manage agency human capital assets.

- Based on the successful launch of the Strategic Workforce Planning Survey system in 2005, OHR has worked with managers to help them act on that objective and provided quantitative data that details the areas and timeframes in which they stand to lose specific types and levels of mission critical employee job competencies through retirements or other attrition. By providing assistance in the use of the online Talent Management Action Plan template, OHR has encouraged planning and responsive action by managers to close the potential talent gaps in their units, since the tool facilitates creation of targeted, prioritized human capital plans down to the level of individual work units. At the same time, OHR and the Office of Information and Technology Services (OITS) have met regularly during the year to enhance the reporting capability of the Strategic Workforce Planning Survey system, so that managers will continue to receive data on competencies at risk of loss. Finally, OHR and OITS supported the first annual update by employees of their online self-assessment surveys, so that the inventory of employee job competencies available to meet the agency mission remains up to date.

- In addition to aiding individual offices and divisions and their subunits to create specific action plans, OHR has acted to address human resource challenges that apply across the agency. Armed with data on trends such as the potential of 40 percent of CFTC supervisory and managerial personnel to retire by 2009, OHR has rolled out a customized suite of online managerial courses from Harvard Business School Publishing and prepared, during FY 2006, to provide all employees with the Skillsoft online training facility. By funding these initiatives, agency management has acted to train employees in the managerial skills required to close the gap in this crucial agency competency that would otherwise develop due to inevitable retirements.

- OHR staff have continued to represent the agency on the Financial Regulatory Agency Group, comprised of Human Resources staff from the financial regulatory agencies that, like the CFTC, must seek comparability with one another under their legislative authority to offer pay and benefits outside of the normal limitations of Title 5 of the U.S. Code that apply to General Schedule and Senior Executive Service positions. These contacts assure that OHR maintains current awareness of pay parity issues, knowledge that is vital to supporting use of the CFTC pay parity authority as a mainstay of strategic planning to compete for mission-critical skills over time.

- OHR staff continue to implement administrative improvements that will speed the recruitment of replacements for retiring employees, when directed. These include online systems that speed security and suitability checks on candidates for employment and support more efficient administrative processes. Examples include the project now underway to convert to the government-wide system of electronic Official Personnel Folders under the Office of Personnel Management's Enterprise Human Resources Integration program.

Challenge #2, Challenges in the Marketplace

FY 2005 IG Assessment:

"The Commodity Futures Modernization Act of 2000 (CFMA) transformed the agency from a prescriptive regulator into an oversight regulatory agency. The agency's regulatory mission over the futures industry is guided by core principles stated in the CFMA. Recent innovations in the industry such as the initial public offerings of major Chicago based futures exchanges and futures commission merchants (FCM) have broadened the impact of any malfeasance within the futures industry. How the agency handles unanticipated events such as market disruptions and FCM bankruptcies will be closely watched by a worldwide audience. To date, management has handled major turbulences that have occurred during the fiscal year."

FY 2006 Actions Taken or Actions in Progress:

- Commission staff reviewed for compliance with the CEA and the Commission's regulations, filings of exchanges submitted to the SEC prior to demutualization and initial public offering, including the review of the CBOT initial public offering and ongoing review of preparations for the NYMEX initial public offering. Staff also have been in contact with SEC staff when requests arise.

- Commission staff reviewed for compliance with the CEA and the Commission's regulations, exchange notifications to the Commission, including merger agreements and purchase and sale agreements, under Commission Regulation 38.5(d) when equity in an exchange is acquired by a new owner, including review of the acquisitions of equity in HedgeStreet, NYMEX and OneChicago. Such review includes evaluation, for compliance with the CEA and the Commission's regulations, of both new exchange governance documents and changes to those documents, including bylaws, articles of incorporation, and limited liability agreements or operating agreements.

- As part of its rule enforcement reviews, Commission staff considered the impact of such changes on the ability of the exchanges to continue to carry out their self-regulatory responsibilities.

- As a result of financial difficulties experienced by Refco, Inc the parent of Refco LLC, a Commission-registered FCM, the Commission mobilized its staff to ensure that all customer segregated funds at Refco LLC, were protected until such time as they were transferred in an orderly manner to other FCMs – including the eventual sale of the remaining customer accounts and certain other assets of Refco LLC, to Man Financial, Inc. (Man) on November 25, 2005. CFTC staff took the following steps to ensure that customers were fully protected: 1) examining the FCM's books and records; 2) undertaking daily calls with Refco staff on issues ranging from transfers of accounts, to satisfaction of clearing obligations, to requests to withdraw capital from the FCM; and 3) coordinating with Commission-registered DCOs to ensure that transactions were processed in a timely manner. The Commission also took an active role in the eventual sale of certain Refco LLC, assets during the bankruptcy proceeding, including consultations with the exchanges, Refco, and potential bidders concerning the means by which the assets could lawfully be sold.