

# INSPECTOR GENERAL'S FY 2007 ASSESSMENT



Office of the  
Inspector General

## U.S. COMMODITY FUTURES TRADING COMMISSION

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**TO:** Walter Lukken  
Acting Chairman

**FROM:** A. Roy Lavik *ARL*  
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**DATE:** November 15, 2007

**SUBJECT:** Inspector General's Assessment Of The Most Serious Management  
Challenges Facing the Commodity Futures Trading Commission (CFTC)

### Introduction

The *Reports Consolidation Act of 2000 (RCA)* authorizes the CFTC to provide financial and performance information in a more meaningful and useful format for Congress, the President, and the public, through publication of the Performance and Accountability Report (PAR). The *RCA* requires the Inspector General to summarize the "most serious" management and performance challenges facing the agency and to assess the agency's progress in addressing those challenges, all for inclusion in the PAR. This memorandum fulfills our duties under the *RCA*.

In order to identify and describe the most serious management challenges, as well as the agency's progress in addressing them, we have relied on data contained in the CFTC financial statement audit and PAR report, as well as our knowledge of industry trends and CFTC operations. Since Congress left the determination and threshold of what constitutes a most serious challenge to the discretion of the Inspector General, 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.

This memorandum summarizes the results of the CFTC's current financial statement audit, describes the agency's progress on last year's management challenges, and finally discusses the most serious management challenges that we have identified: Modernization of Electronic Market Surveillance and Expansion of CFTC Oversight into New Markets.

### **CFTC Financial Statement Audit Results**

In accordance with the *Accountability of Tax Dollars Act*, CFTC, along with numerous other federal entities, is required to submit to an annual independent financial statement audit by the Inspector General, or by an independent external auditor as determined by the Inspector General. In 2004, the Office of the Inspector General (OIG) selected KPMG LLP, an independent public accounting firm, to conduct the required audit. Since then, KPMG LLP has annually conducted an audit of the CFTC's financial statements on the OIG's behalf and has rendered an opinion on the statements. The results of the KPMG audit are discussed in the PAR, and I am pleased to state that, for Fiscal Year 2007, the financial statement audit resulted in an unqualified audit opinion.

### **CFTC's Progress on Last Year's Challenges**

Last year we identified two most serious management challenges: Industry Consolidations, and Exchange Trading Revolutions. Events in 2007 have reinforced our prior assessment of the serious management challenges facing the CFTC. During the past year, the CME-CBOT and NYBOT-ICE mergers reflected our previously stated concern that industry consolidations might significantly impact how the CFTC allocates staff resources to fulfill its regulatory mission. Furthermore, these mergers have accelerated the structural change towards trading on electronic platforms, while triggering a significant diminution of on-floor trading. Electronic futures and options trading on all domestic exchanges accounted for 74% of trading volume during 2007 (through August 2007), compared with 64% last year.

Our review leads us to conclude that the agency has responded effectively to these management challenges. The agency's achievements are remarkable given the historically low full-time-equivalent staff (approximately 437 FTEs) employed at the agency during this recent fiscal year. However, we are uneasy about the CFTC's comparatively low funding. If it continues, the agency may be adversely impacted in its ability to conduct its mission.

### **Most 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. Although the PAR identified challenges by program areas, the OIG adopted a broader agency-wide perspective in selecting management challenges. Given the aforementioned conditions and based on our familiarity with the CFTC and our review of current industry trends, we have identified two potential management challenges which we believe will challenge the CFTC in the coming year. Modernization of Electronic Market Surveillance and Expansion of CFTC Oversight into New Markets will stress the regulatory resolve of the CFTC in allocating its staff to its market oversight mission as mandated by Congress.

### **Modernization of Electronic Market Surveillance**

Last year we stated that the migration to trading on largely electronic exchanges challenged whether the agency has sufficient information technology infrastructure and staff to efficiently and effectively conduct timely surveillance of these dynamic and economically essential global markets. Continued expansion of electronic trading leads us to restate this concern and to emphasize the need for the CFTC to modernize and develop enhancements to its electronic market surveillance techniques and to establish new procedures for training its staff (who historically relied on trading floor based surveillance of derivatives markets) on how to carry out its regulatory mission under this new industry paradigm of electronic exchange trading.

The existing CFTC electronic market surveillance system relies on data systems that are the outgrowth of late twentieth century technology. It is suitable for an update in the twenty-first century. We applaud the agency's current efforts to develop an updated market surveillance system. Yet there remains a valid concern that both staff and new agency systems will be challenged if growth in electronic trading continues at its current rate. Our concern is further heightened by the second year of stagnant budgetary resources. This lack of funds will impact the agency's ability to invest in technological modernization, and to effectively maintain its electronic oversight of the largely electronic exchanges under its regulatory purview.

### **Expansion of CFTC Oversight into New Markets**

Exempt Commercial Markets – an area that in the past has not received significant agency resources – is increasingly demanding more attention. During the past year, members of Congress and industry leaders have expressed concern that, where Exempt Commercial Markets (that are largely electronic trading platforms) generate commodity prices that can impact the price discovery of equivalent exchange traded commodities, the CFTC ought to acquire greater awareness of those transactions, thus forcing the agency to reevaluate its previous regulatory model of focusing principally on designated exchange trading oversight. This expansion of the CFTC's oversight mission – regardless of whether expansion is legislated through Congressional action or expanded within the existing agency regulatory scheme – may strain agency human resources, as well as electronic market surveillance systems.

### **Conclusion**

We are optimistic that, with an adequate Fiscal Year 2008 budget, the CFTC will be able to address these management challenges, as well as those identified in the PAR. We look forward to identifying solutions to assist the CFTC in rendering the most cost-effective oversight of these burgeoning financial markets. We will partner with the Government Accountability Office, when necessary, to evaluate existing CFTC oversight in areas ranging from energy, human resources and new products such as emissions reduction trading. 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.