



## U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre  
1155 21st Street, NW, Washington, DC 20581  
Telephone: (202) 418-5110  
Facsimile: (202) 418-5522

Office of the  
Inspector General

### MEMORANDUM

**TO:** Walter Lukken  
Acting Chairman

**FROM:** A. Roy Lavik *ARL*  
Inspector General

**DATE:** November 14, 2008

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

#### 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 CFTC and to assess the CFTC'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 CFTC's progress in addressing them, we have relied on data contained in the CFTC financial statement audit and PAR, 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 Efficient Acquisition and Integration of Skilled Human Capital.

### **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 2008, the financial statement audit resulted in an unqualified audit opinion.

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

Last year we identified the two most serious management challenges: Modernization of Electronic Market Surveillance, and Expansion of CFTC Oversight into New Markets. Events in 2008 have reinforced our prior assessment of the serious management challenges facing the CFTC. During the past year, the Agency has expended approximately \$11 million dollars (more than 10% of its FY 2008 budget) to update its antiquated electronic surveillance systems. In addition Congress, with the passage of the Farm Bill in May 2008,<sup>1</sup> codified and expanded the Agency's responsibilities over the Exempt Commercial Market with Significant Price Discovery Contracts (ECM-SPDC). The passage of this legislation addressed the FY 2008 Assessment of the Agency's Most Serious Management Challenges. Nonetheless, we remain concerned about two areas that are an extension of last year's Management Challenges.

### **Most Serious Management Challenges for Fiscal Year 2009**

During the past year, the industry has continued its inexorable march towards a completely electronic marketplace. For example, the Minneapolis Grain Exchange will close its trading floor on December 19, 2008. Thus, we will restate our concern about Modernization of Electronic Market Surveillance. Our second concern is the Efficient Acquisition and Integration of Skilled Human Capital to address expanding Congressional mandates.

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

Prices for exchange traded commodities directly affect the global economy. Effective market surveillance techniques necessary to detect and prevent trading and price distortions are therefore essential to the CFTC's mission. While market surveillance has always been an integral part of CFTC operations, the past years have witnessed the transformation of futures trading from an open outcry trading floor based system to an electronic system. And in 2008, electronic trading

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<sup>1</sup> The formal name of the Farm Bill is the "Food, Conservation, and Energy Act of 2008," which is HR 2419. The citation is Public Law 110-234, 122 Stat. 923. The CFTC Provisions are in Title XIII of the legislation, titled the "CFTC Reauthorization Act of 2008."

continued to expand, accounting for over 84%<sup>2</sup> of total exchange traded derivatives. This structural change demands that the Agency redefine its market surveillance techniques.

Although the Agency has dramatically expanded its financial commitment to modernizing its electronic surveillance systems, we are not convinced that it has strategically evaluated its market surveillance mission. Thorough analysis of evolving oversight markets, mission and resources can enhance the development of updated surveillance techniques. Enhanced surveillance techniques, coupled with the efficient allocation of Agency resources, will serve the mission of protecting the financial marketplace against artificial prices for global commodities.

Our review of the Agency's fiscal year 2009 budget revealed that the Agency will increase its spending on information technology to nearly \$26 million. We look forward to monitoring the Agency's efforts in this area to assure that taxpayer funds will be prudently and efficiently allocated to protect the integrity of the marketplaces under the oversight of the CFTC.

### **Efficient Acquisition and Integration of Skilled Human Capital**

Recent economic turbulence has stimulated an interest in applying the historically successful centralized clearing mechanism to the bilateral and complex swap markets. It has also stirred debate about the current financial market regulatory structure. Should Congress elect to assign the CFTC a specific oversight role for the financial swaps markets, we are skeptical that the Agency currently has the human capital sufficient to monitor these complex markets. Moreover, reorganization of the financial market regulators could result in additional challenges.

Our evaluations of Congressional statements indicate that, presuming CFTC does not undergo significant change, the Agency may be allocated additional budgetary resources that may expand its full time equivalent (FTE) staff by nearly 23 percent over the fiscal year 2008 level of 448 FTE. The complexity of the derivatives marketplace may demand reevaluation of existing hiring procedures (flexibility). It may also require astute evaluation of potential employees in order to develop a workforce that can significantly aid the Agency in addressing additional responsibilities granted by Congress and the significant complexity of the markets under CFTC oversight.

We view the possibility of a dramatic increase in new employees, as well as the possible restructuring of the financial market regulatory agencies, as potentially significant management challenges.

### **Conclusion**

This year's activities in the derivatives markets have stimulated members of Congress, the Government Accountability Office, and average citizens all to increase their awareness of the CFTC. As a result, both the OIG and the Agency have received numerous requests for information and assistance. So far, this Office has responded to all the queries it has received

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<sup>2</sup> 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 [2006]. Source: Inspector General's Assessment Of The Most Serious Management Challenges Facing the Commodity Futures Trading Commission (CFTC) November 15, 2007.

with fact based and independent analyses that seek to address all concerns posed by these and other stakeholders. In fiscal year 2009, we look forward to additional questions and stand ready to offer an independent assessment of the operational status of the Agency. The OIG takes its mission and authority seriously and remain committed to promote integrity, accountability and transparency at the CFTC.