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Office of the
Inspector General

MEMORANDUM

TO: Gary Gensler
Chairman

FROM: A. Roy Lavik ARL
Inspector General

DATE: November 16, 2009

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, 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:

1. Harmonization of CFTC and Securities and Exchange Commission (SEC) Overlapping Regulations;
2. CFTC's Regulatory Model for the Swaps Derivatives Market; and,
3. CFTC's Regulatory Responsibilities over the Potential Carbon Emission Trading 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. The results of the fiscal year 2009 financial statement audit are discussed in the PAR, and 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 as: Modernization of Electronic Market Surveillance and the Efficient Acquisition and Integration of Skilled Human Capital to address expanding Congressional mandates. During fiscal year 2009 the Agency has addressed both issues. Over the past year the Agency has upgraded its servers and trade analysis systems to modernize and improve its surveillance of exchange traded futures and options contracts. As the Agency acquires additional regulatory responsibilities, we hope that the Agency is able to scale up its market surveillance capabilities. Since the start of FY 2009 the Agency has increased its staff by 100 new employees (a 21% increase). This dramatic influx of manpower should assist the Agency in meeting its expanding regulatory mission. The OIG is conducting a review of the recent recruitment in order to evaluate the effect of the CT pay system on recruitment and retention, which review will examine the skill sets of this new talent pool.

Most Serious Management Challenges

Three issues likely to challenge the CFTC in the coming year are: Congressional demand that the CFTC and SEC harmonize their regulation of overlapping financial products; a decision on the CFTC's regulatory model for the swaps derivatives market; and expansion of CFTC's regulatory responsibilities over the potential carbon emission trading markets.

Harmonization of CFTC and SEC Overlapping Regulations

On June 17, 2009, the White House released a White Paper on Financial Regulatory Reform calling on the SEC and CFTC to "make recommendations to Congress for changes to statutes and regulations that would harmonize regulation of futures and securities."[1] Specifically, the White House recommended "that the CFTC and the SEC complete a report to Congress by Sept. 30, 2009, that identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explains why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or makes recommendations for changes to statutes and regulations that would eliminate the differences."[2]

In September 2009, the CFTC and SEC collaborated on an initial effort to begin implementation of the White House mandate, and released the required joint report on October 16, 2009. This effort identified numerous areas for operational coordination that will require substantial analysis and may yield a more efficient regulatory structure over the financial markets. The OIG looks forward to the resulting regulatory model that will define the future mission of this Agency.

CFTC's Regulatory Model for the Swaps Derivatives Market and the Need for Additional Human Capital

Congressional deliberations over how the CFTC will regulate the swaps markets will determine the Agency's need for additional human capital to regulate these markets. The Congressional Budget Office estimates that up to 235 employees[3] may be needed by fiscal year 2011 to regulate central counterparty clearing of swaps. In our estimation, this would require a 40% increase over existing staffing levels--a considerable challenge for any organization. We believe both the intricacies of any forthcoming derivatives regulation and the acquisition of human capital to carry out the regulatory tasks will challenge the CFTC in the coming year.

CFTC's Regulatory Responsibilities over the Potential Carbon Emission Trading Markets

Congress may soon move forward on new legislation to regulate carbon emissions trading. A recent Congressional Budget Office study projected that trading in carbon offsets could be a $60 billion market in 2012.[4] Presuming Congress assigns regulatory responsibility to the CFTC, the CFTC will require additional staffing increases in order to absorb this additional regulatory responsibility. We believe the increased responsibility will challenge the CFTC in the coming year.

Conclusion

The past year has continued to witness dramatic movement in the financial markets and the commodity futures markets. While the Agency has addressed the most serious management challenges identified last year, Congressional initiatives to overhaul regulation of over-the-

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[1] Financial Regulatory Reform: A New Foundation, p.14
http://www.financialstability.gov/docs/regs/FinalReport_web.pdf
[2] Id., pg. 50.
[3] H.R. 3795 Derivative Markets Transparency and Accountability Act of 2009 Congressional Budget Office Cost Estimate November 6, 2009 Page 3. http://www.cbo.gov/ftpdocs/107xx/doc10703/hr3795hfs.pdf.
[4] H.R. 2454 American Clean Energy and Security Act of 2009 Congressional Budget Office Cost Estimate June 5, 2009 Page 11 http://www.cbo.gov/ftpdocs/102xx/doc10262/hr2454.pdf

counter derivatives and the carbon markets may provide a new set of challenges and greatly expand the work of the Agency. Our concern is that Congress adequately equip the Agency with sufficient resources to carry out all additional responsibilities efficiently and effectively, and that the Agency implement any new authority with skill and speed. During the coming year we will monitor the Agency's progress addressing the most serious management concerns, while continuing to identify new challenges. The OIG takes its mission and authority seriously, and remains committed to promoting integrity, accountability and transparency at the CFTC.