

The Future of Futures Regulation

CFTC ROLE DEBATED

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N THE COMMODITY FUTURES TRADING COMMISSION is, in some respects, a victim of its own success. Launched in 1975 to take futures regulation out of the sphere of the Agriculture Department, the CFTC made possible the subsequent explosion of nonagricultural futures, including energy and financial futures.

And then in 2000, in an enlightened move, Congress passed the Commodity Futures Modernization Act, which shifted the CFTC from a rules-based regulator to a principles-based regulator and made it possible for the rapid pace of innovation in the futures markets to continue without being stymied by the approval process of a slow-moving regulatory bureaucracy.

The result for the futures markets has been stunning. The Chicago Mercantile Exchange, the leading futures market, is now valued at \$37 billion, half again as much as the \$24 billion value attributed to NYSE Euronext, the operator of the venerable New York Stock Exchange. Not only hedge funds, but pension funds, university endowments, and even staid mutual funds and retail investors are pouring more money into futures contracts instead of the traditional stocks and bonds, trying to get a piece of the commodities boom.

But what about the CFTC? It is currently operating on borrowed time, some two years past its legislative expiration date as Congress dawdles over its "reauthorization." It has trouble keeping a chairman, often operating months on end, as now, with an "acting" chairman. It also has trouble keeping its full complement of five commissioners, sometimes dwindling as low as two commissioners. It currently has four.

In the meantime, the U.S. Treasury is making noises about merging CFTC into the larger and older Securities and Exchange Commission as it explores the possibility of regulatory consolidation – combining the hodgepodge of U.S. financial regulators into a single, streamlined agency as have other major industrial countries – to keep U.S. financial markets competitive. At the same time, the

Federal Energy Regulatory Commission, brandishing its new congressional mandate from the energy act of 2005 to prosecute manipulation of energy prices, is challenging CFTC's jurisdiction in the Amaranth case.

As the lame-duck Bush administration limps its final laps and a Democratic Congress somehow is unable to channel its majorities into any significant legislation, it's not likely that the bigger plans for the CFTC will be achieved anytime soon. But it also



Walter Lukken became acting chairman of the Commodity Futures Trading Commission in June.
SOURCE: AP PHOTO/CHARLES DHARAPAK

means that some of the smaller issues – such as reauthorization and designation of a permanent chairman – may also be slow in getting resolved.

One concrete measure seems likely to get enacted, in line with Washington's practice of shutting the barn door after the horse has gotten out. The over-the-counter contracts that made it possible for Amaranth to hide its positions in natural gas futures once it had reached its limits in trading on the New York Mercantile Exchange are likely to come under the supervision of the CFTC. In hear-

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ings before various House and Senate committees as well as at the CFTC itself, it became clear that contracts on unregulated trading venues, known as exempt commodities markets (ECMs) can influence prices when they mimic the contracts traded on official exchanges, known as designated contract markets (DCMs).

Specifically in the Amaranth case, the Henry Hub contracts traded on ICE Futures, a subsidiary of Atlanta-

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based Intercontinental Exchange, mimicked Nymex's contract, right down to the settlement price, allowing Amaranth to build up a huge position undetected by the CFTC or any exchange surveillance.

In October testimony to the House Agriculture subcommittee that oversees the CFTC, acting chairman Walt Lukken praised ECMs for acting as "incubators for new concepts and provide robust competition with DCMs." However, he goes on to say, "The reality that some ECM contracts are serving a significant

price discovery function leads the commission to conclude that changes to the Commodity Exchange Act are necessary in order for the commission to detect and prevent manipulation in these markets."

Lukken emphasized that the added surveillance should only affect these duplicate contracts.

The CFTC recommended to Congress that new legislation amend the CEA so that when an ECM futures contract is determined to serve a significant price discovery function, the CFTC would have the authority to require large trader position reporting for that contract; require an ECM to adopt position limits or accountability levels for that contract; require an ECM to exercise self-regulatory responsibility over that contract in preventing manipulation; and exercise emergency authority regarding such transactions.

This would affect some of the natural gas and oil contracts on ICE, and could affect any OTC contracts, in electricity or any other field, once they came to have a significant impact on market pricing.

For Lukken, the hectic round of testimony and speeches in the fall comes as his agency survives by means of continuing resolutions and he himself is designated only acting chairman. Lukken's appointment as acting chairman came as Reuben Jeffery ended his short-lived tenure as chairman last summer. After Jeffery's departure in June, the commission was down to just two members, before Jill Sommers, a veteran of the International Swaps and Derivatives Association and the Chicago Mercantile Exchange, and Bart Chilton, a former aide to Democratic leader Sen. Tom Daschle, were sworn

in during August. The CFTC was in a similar situation some months before Jeffery's appointment in 2005. It was down to just two members at one point in 2004 under longtime acting chairman Sharon Brown-Hruska. Lukken was the other one.

As with other federal agencies, the CFTC is obliged to keep a political balance, with each party allotted at least two members on the five-member commission, and the chairman generally belonging to the party in the White House. Lukken and Sommers are Republicans, while Chilton and Michael Dunn, an expert in farm credit who joined the commission in December 2004, are Democrats. So the remaining commission position and the permanent chairmanship are open for a Republican appointee. Lukken is considered to be a viable candidate to be confirmed as permanent chairman – especially given the prospect of a Democratic administration after next year's election.

The political enfeeblement of the current administration also makes it unlikely that Treasury Secretary Henry Paulson will make much progress with his efforts at regulatory consolidation. Treasury's request for comments drew hundreds of responses. The securities industry, represented by the Securities Industry and Financial Market Association, came out in favor of merging the CFTC and SEC – clearly hoping that the principles-based regime of the former would become the norm at the merged entity and ease the burden of the SEC's highly prescriptive rules-based regulation.

NYSE Euronext said the two agencies would probably be united if they were being created from scratch today, but each agency has too much history to be able to merge easily. Most of the major players in the futures market also argued to keep the agencies separate, fearing that futures regulation would get bogged down again in the merged entity.

What is much more likely – and this is the recommendation of the NYSE – is that the President's Working Group on Financial Markets, which brings together the heads of the various regulatory agencies, will play a more active role in coordinating activities among the various agencies.

In the meantime, CFTC will have to sort out its jurisdictional dispute with FERC regarding the type of market manipulation practiced by Amaranth. CFTC is holding that it has exclusive jurisdiction over the futures market, while FERC says its new obligation to prosecute energy price manipulation has to extend to cases like Amaranth where speculation in the futures market affected spot prices.

CFTC commissioner Chilton had some scathing words for FERC in a recent speech. "The problem arose when FERC decided to take their new act for a little jurisdictional test drive in the Amaranth case," Chilton said. "But they took their act on the road too soon, I think, and it has resulted in a rendition of dueling government banjos."

While Collin Peterson (D-Minn.), chairman of the House Agriculture Committee, along with several other members of the committee, was happy to write a letter affirming CFTC's exclusive jurisdiction, the lawmaker nonetheless said, "We applaud the anti-manipulation efforts of the CFTC and the FERC and we encourage both agencies to continue to work together to protect the integrity of the energy market."