Testimony of Reuben Jeffery III, Chairman
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Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am pleased to have an opportunity to testify on behalf of the CFTC on the regulation of hedge funds.

I will focus my remarks today on how hedge funds intersect with the CFTC's statutory responsibilities under its governing statute, the Commodity Exchange Act (the CEA). At the outset, I should emphasize that the CFTC does not regulate "hedge funds" per se. However, the CFTC encounters hedge funds as it performs two of its critical missions under the CEA: promoting market integrity and protecting the public from fraud in the sale of futures and commodity options. Hedge funds are on the CFTC's market surveillance radar when they trade in the regulated futures and commodity options markets. With respect to investor protection, if a collective investment vehicle, such as a hedge fund, trades futures or commodity options, the fund is a "commodity pool" and its operator and advisor may be required to register with the CFTC and meet certain disclosure, reporting, and recordkeeping requirements.

My testimony today will address four topics. First, I will share some observations regarding the participation of hedge funds in the regulated futures markets. Second, I will describe the CFTC's surveillance methods used to monitor large traders, including many hedge funds. Third, I will describe the CFTC's investor protection regime aimed at protecting investors

from fraudulent practices in the sale of commodity pools, including hedge funds. Finally, I will comment on our recent enforcement activities involving commodity pools and hedge funds.

Participation of Hedge Funds in Futures Markets

Futures markets serve an important role in our economy by providing a means of transferring risk from those who do not want it to those willing to accept it for a price. Traders who are trying to reduce their exposure to price risks, that is, "hedgers," typically include those who have an underlying commercial interest in the commodity upon which the futures contract is based. For example, futures contracts allow a bank to transfer its risk exposure to rising interest rates, a grain merchant to hedge an expected purchase of corn, or an oil refiner to lock in the price of its heating oil and gasoline output. In order for these hedgers to reduce the risk they face in their day-to-day commercial activities, they need to trade with someone willing and able to accept the risk. Data from the CFTC's Large Trader Reporting System indicate that hedge funds, and other professionally managed funds, facilitate the needs of commercial hedgers to mitigate their price risks, and add to overall trading volume, which contributes to the formation of liquid and well-functioning markets.

CFTC large trader data also show that hedge funds and other professionally managed funds hold significant arbitrage positions between related markets. These arbitrage positions are structured to profit from temporary mispricing between related contracts (*e.g.*, prices for October delivery vs. prices for November delivery) and, when structured as such, are unrelated to the overall level of futures prices. These arbitrage trades play a vital role in keeping prices of related

markets (and prices of related contracts within the same market complex) in proper alignment with one another.

One notable market development in recent years has been increased participation by hedge funds and other financial institutions in futures markets for physical commodities. These institutions view commodities as a distinct "asset class" and have allocated a portion of the portfolios they manage into futures contracts tied to commodity indexes. The total investment in commodity-linked index products by pension funds, hedge funds and other institutional investors has been estimated by industry observers to exceed $100 billion in assets. A significant portion of this amount finds it way into the regulated futures markets, either through direct participation by those whose commodity investments are benchmarked to a commodity index, or through participation by commodity index swap dealers who use futures markets to hedge the net risk associated with their dealing activities. Notably, although the percentage of participation by hedge funds has increased in recent years, commercial traders in these markets remain, by far, the largest segment of trading category.

Surveillance Methods Used by the CFTC to Monitor Large Traders—Including Hedge Funds

In the CFTC's world of regulated futures exchanges, market integrity is essential to preserving the important functions of risk management and price discovery that the futures markets perform in the U.S. economy. The CFTC relies on a program of market surveillance to ensure that markets under CFTC jurisdiction are operating in an open and competitive manner, free of manipulative influences or other price distortions. The backbone of the CFTC's market surveillance program is its Large Trader Reporting System. This system captures end-of-day

position-level data for market participants meeting certain criteria. Positions captured in the Large Trader Reporting System typically make up 70 to 90 percent of all positions in a particular exchange-traded market. The Large Trader Reporting System is a powerful tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate the market. For surveillance purposes, the large trader reporting requirements for hedge funds are the same as for any other large trader.

Using large trader reports, CFTC economists monitor futures market trading activity, looking for large positions that might be used to manipulate prices. Each day, for all active futures and option contracts traded on the regulated exchanges, surveillance staff members monitor the daily activities of large traders and key price relationships. In addition, CFTC market analysts maintain close awareness of supply and demand factors and other developments in the underlying cash markets through review of trade publications and government reports, and through industry and exchange contacts. Staff also closely tracks the net positions of managed money traders as a class to monitor for any market irregularities or trends. The CFTC's surveillance staff routinely reports to the Commission on surveillance activities at weekly surveillance meetings.

Market surveillance, however, is not conducted exclusively by the CFTC. Each futures exchange is required under the CEA to affirmatively and effectively supervise trading, prices, and positions. The CFTC examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfilling this important responsibility. The CFTC staff's findings from these rule enforcement reviews are reported to the CFTC, and are publicly posted on the

CFTC Website (www.cftc.gov). Furthermore, exchanges impose position limits, where appropriate, to guard against manipulation. For example, NYMEX imposes spot month speculative limits on its energy contracts.

When the CFTC's surveillance staff identifies a potentially problematic situation, the CFTC engages in an escalating series of communications with the largest long- and short-side traders -- which may be hedge funds -- to address the concern. Typically, the CFTC's staff consults and coordinates its activities with exchange staff. This targeted regulatory oversight by CFTC staff and the exchanges is quite effective in resolving most potential problems. However, hedge funds normally roll out of positions prior to the expiration month when manipulation is most likely to occur, because most do not have the capabilities to make or take delivery of the underlying commodity.

Given the CFTC's statutory role as an oversight regulator, and the exchanges' statutory responsibility to monitor trading to prevent manipulation, the law requires that the exchanges take the lead in resolving problems in their markets, either informally or through emergency action. If an exchange fails to take actions that the CFTC deems necessary, the CFTC has broad emergency powers to direct the exchange to take such action which, in the CFTC's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. Fortunately, most issues are resolved without the need for the CFTC's emergency powers, as the CFTC has had to take emergency action only four times in its history.

Just as the CFTC's market surveillance program monitors the activity of all large traders on the regulated futures exchanges to maintain an orderly operation of the markets, the system of financial safeguards in the futures industry is focused on ensuring that the financial distress of any single futures market participant, whether it be a hedge fund or any other participant, does not have a disproportionate effect on the overall market. This is primarily accomplished through a clearinghouse's financial safeguards. This includes the margin deposited by clearing member firms and guarantee funds. Futures clearinghouses perform periodic risk evaluations of clearing member firms in an attempt to detect potential weaknesses in financial condition or risk controls. In addition, each firm has its own financial and capital safeguards in place to protect itself from the financial distress of a customer—including a hedge fund customer.

CFTC's Oversight Authority with Respect to Operators and Advisors of Commodity Pools, Including Hedge Funds

Of no less importance is the CFTC's responsibility to protect investors who participate - whether directly or through participation in a professionally managed fund - in the futures markets through a diverse array of commodities products. To that end, the CFTC maintains a customer protection regime that, pursuant to the CEA, relies on full and timely disclosure to protect investors from abusive or overreaching sales practices. This encompasses participation in commodity pools, including hedge funds.

Registration is the cornerstone of the CFTC's customer protection scheme. As of June 30, 2006, there were approximately 1,600 Commodity Pool Operators (CPOs) and 2,600 Commodity Trading Advisors (CTAs) registered with the CFTC, operating and advising approximately 2,300 commodity pools. In annual reports filed for 2005, these CPOs reported

total assets under management for commodity pools of approximately $700 billion, of which less than five percent represent direct investments in the futures markets.

The primary purposes of registration are to ensure a person's fitness to engage in business as a futures professional and to identify those persons whose activities are covered by the CEA. Generally speaking, those who operate or manage a commodity pool must register with the CFTC as CPOs, and those who make trading decisions on a pool's behalf must register as CTAs. Registration is not dependent on whether commodity interests are traded for speculative or hedging purposes, or on whether they are the predominant investment traded or advised. Notable exclusions or exemptions are available for operators of pools that are otherwise regulated; that have only sophisticated participants and de minimis commodity interest trading; and that have only the very highest level of sophisticated participants, regardless of the amount of commodity interests traded. Hedge fund operators frequently fall within one of the latter two exemptions from CPO registration.

Once registered, a CPO or CTA must comply with certain disclosure, reporting, and recordkeeping requirements designed to ensure that prospective and current participants in commodity pools receive all the information that is material to their decision to make, or maintain, an investment in the pool. For example, prospective participants must receive information regarding the pool's investment program, risk factors, conflicts of interests, and performance data and fees. Thereafter, a CPO must provide pool participants with an account statement at least quarterly, and an annual report containing specified financial statements which

must be certified by an independent public accountant and presented in accordance with Generally Accepted Accounting Principles (GAAP).

The CFTC has established a simplified regulatory framework for registered CPOs and CTAs who operate or advise pools whose participants meet certain criteria. Relief from full compliance with the disclosure, reporting, and recordkeeping requirements is available where, for example, pool participants are CFTC or SEC registrants, "inside employees" of the CPO or CTA, or persons who earn $200,000 annually and who have assets worth at least $2 million. Many of the pools for which CPOs are exempt from disclosure, reporting, and recordkeeping regulations are likely to be hedge funds.

Having outlined what CFTC regulation involves, it is important to note the limits of that regulation. The CFTC's mandate under the CEA does not include imposing limits on the pool's market risk or leverage parameters, or the instruments that may be traded, or imposing capital requirements or risk assessment procedures.

Finally, day-to-day oversight functions of CPOs and CTAs are carried out by the National Futures Association (NFA), the futures industry analogue of the National Association of Securities Dealers. NFA's responsibilities include the registration processing function and review of CPO and CTA disclosure documents and pool financial statements. Consistent with the disclosure-based regulatory regime under the CEA, review of pool financial statements focuses on ensuring that they include all required information and conform to applicable accounting standards, but does not include an analysis of the pool's underlying transactions

themselves. As part of its self-regulatory responsibilities, NFA conducts on-site examinations of CPOs and CTAs on a routine, periodic basis. NFA generally examines all CPOs and CTAs within two years of their becoming active, and every four years thereafter.

CFTC Enforcement Overview: Commodity Pools, Hedge Funds and CPOs

The CFTC takes its enforcement responsibilities with respect to CPOs, CTAs, and commodity pools very seriously. Whether registered or unregistered, exempt or not exempt, CPOs and CTAs remain subject to the CFTC's anti-fraud authority.

Over the past 6 fiscal years, the CFTC has brought 49 enforcement actions involving commodity pools, hedge funds and CPOs. These enforcement actions typically involve investments in commodity pools, including self-styled hedge funds, in which the investors' funds were misappropriated or misused, or where investors were victimized by solicitation fraud involving misrepresentations of assets under management and/or profitability. The CFTC's Division of Enforcement currently has 55 pending investigations of commodity pools, hedge funds and CPOs.

The majority of the CFTC's pool fraud cases have been brought against unregistered CPOs. These cases tend to involve ponzi schemes or outright misappropriation, as opposed to legitimate hedge fund operations. Sanctions in CFTC enforcement actions can include permanent injunctions, asset freezes, prohibitions on trading on CFTC-registered entities, disgorgement of ill-gotten gains, restitution to victims, revocation or suspension of registration, and civil monetary penalties.

The CFTC has taken enforcement action in several well-publicized recent hedge fund frauds. While the futures activities of these funds were not necessarily the primary cause of the problems, the CFTC took action against its registrants to punish their illegal conduct, deter future violations, and seek recovery of monies taken from innocent victimized investors. The following cases filed during the past year are illustrative:

On June 21, 2005, the CFTC filed an enforcement action against Philadelphia Alternative Asset Management Co., LLC (PAAM), a registered CPO, and Paul M. Eustace, a registered associated person and president of PAAM, alleging fraudulent solicitation and false reporting involving hedge funds and commodity pools. On the day that the complaint was filed, the CFTC froze approximately $70 million of the defendants' assets.

On September 29, 2005, the CFTC filed an enforcement action alleging misappropriation and fraud involving Connecticut hedge fund manager and registered CPO Bayou Management, LLC (Bayou Management), its principals Samuel Israel III (a registered associated person) and Daniel E. Marino, and Richmond Fairfield Associates, Certified Public Accountants. The complaint alleges that the defendants misappropriated customer funds, acquired funds through false pretenses, engaged in unauthorized trading, and misrepresented material facts to actual and prospective investors, including the rates of return the hedge funds earned, the value of assets under management, and the existence and identity of the accounting firms that had purportedly audited the hedge funds.

In many instances, the CFTC works cooperatively with NFA, state regulators, criminal authorities and/or the SEC in bringing such actions. In Bayou, for example, Israel and Marino, based upon the same conduct alleged by the CFTC, pleaded guilty to criminal charges brought

by the U.S. Attorney's Office for the Southern District of New York. The CFTC also coordinated its Bayou investigation with the SEC, which filed a parallel enforcement action under the federal securities laws.

Conclusion

In closing, the CFTC's primary mission under the CEA includes ensuring market integrity and customer protection. Hedge funds that trade futures and commodity options on CFTC-regulated exchanges implicate both. Thus, the CFTC monitors participation by hedge funds in the regulated futures markets, as it does with other large traders, in order to ensure that these markets operate free of price distortions. The CFTC also administers a disclosure-based regime designed to ensure that investors participating in commodity pools receive all the information that is material to their decision to invest in pools; when problems are uncovered, the full force of the CFTC's enforcement authority is devoted to prosecuting those responsible. The CFTC will remain vigilant in utilizing the tools provided in the CEA - market surveillance, disclosure, reporting and recordkeeping, and enforcement authority – to fulfill its statutory responsibilities as hedge fund participation in the futures markets continues to expand.

This concludes my remarks. I look forward to your questions.