Testimony **of**
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Mr. Chairman, Senator Sarbanes and members of the Committee, I appreciate the opportunity to appear on behalf of the Commodity Futures Trading Commission (CFTC) at this hearing on the reauthorization of the Commodity Exchange Act (CEA).

Congress's most recent exercise in reauthorizing the CEA resulted in the Commodity Futures Modernization Act of 2000 (CFMA). It was, most assuredly, landmark legislation under which the futures industry has flourished. This Committee deserves credit for its role in the CFMA's development. The CFTC concurs with the widely-held view that this reauthorization – unlike the sweeping nature of the CFMA – should involve only incremental changes to the CEA.

The issue in this legislative round that has received the most public attention involves the CFTC's antifraud authority with respect to retail foreign currency transactions in light of the *Zelener* decision. *CFTC v. Zelener*, 373 F.3d 861 (7th Cir.), *rehearing denied en banc*, 387 F.3d 624 (7th Cir. 2004) (*Zelener*). I am pleased to note that the staff of the President's Working Group on Financial Markets (PWG) has reached an agreement in concept on a legislative recommendation to address the post-*Zelener* situation, though the final details are being worked out for approval by the PWG Principals.

I will cover today the issues the Committee specifically asked us to address, as well as two others of importance to the CFTC: 1) risk-based and portfolio margining for both security futures products (SFPs) and for security options; 2) clarification of exclusions from the CEA's definition of narrow-based security index; 3) the *Zelener*/retail foreign currency fraud consensus proposal endorsed by the PWG; 4) amendments to Section 4b of the CEA providing the Commission with clear "principal-to-principal" antifraud authority over off-exchange futures transactions; and 5) amendments to Section 9 of the CEA clarifying the Commission's authority to bring administrative and civil actions as well as increasing civil and criminal penalties.

Risk-Based Portfolio Margining of Security Futures Products and Security Options

Section 7 of the Senate Agriculture Committee bill as reported, S. 1566, provides for the institution of a pilot program for risk-based portfolio margining of SFPs. The CFTC supports risk-based and portfolio margining for both SFPs and security options.[1] Risk-based margining and portfolio margining, standard in the futures industry, are both efficient and effective from a regulatory point of view, and have been remarkably successful in protecting customer funds.

[1] Risk-based margining, as opposed to strategy-based margining, establishes margin levels based upon an analysis of the historical performance and expected price volatility of individual products. Risk-based margin requirements are designed to cover the expected one-day price movement with an established level of statistical confidence (generally 99%). Risk-based portfolio margining establishes margin levels by assessing the net market risk of a portfolio of positions in an account. Portfolio margining is based upon the premise that combinations of positions can have offsetting risk characteristics due to historic or expected correlations in their price movements. Under a risk-based portfolio margining system, the minimum level of margin is determined by 1) analyzing the risk of each component position in an account and 2) recognizing any risk offsets in an overall portfolio of positions. Portfolio margining, as opposed to strategy-based margining, more accurately evaluates the economic risks of open positions, thereby minimizing the chance of over-margining or under-margining. In addition, portfolio margining acknowledges the reality that an offsetting position can be a better risk mitigant than deposited collateral.

The use of a more risk-sensitive, portfolio-based approach to margining for financial products has received wide support. For example, the Federal Reserve Board of Governors expressed support for risk-based and portfolio margining in its March 2001 letter to the Securities and Exchange Commission (SEC) and CFTC delegating margin authority over SFPs. The Board specifically noted its expectation that the creation of this new product would promote opportunities for portfolio margining for all securities, including security options and SFPs.

The SEC has also taken steps that show support for risk-based and portfolio margining. On July 14, 2005, the SEC approved a Chicago Board Options Exchange (CBOE) two-year pilot program for portfolio margining and cross margining[2] with respect to certain products. On the same date, the SEC also approved New York Stock Exchange (NYSE) rule changes that would enable NYSE members to participate in the CBOE pilot program. However, SFPs are not included in the portfolio margining provisions of the pilot program, and therefore it would not directly facilitate the use of portfolio margining for these products. In addition, while broad-based securities index futures and broad-based equity options are included in the cross-margining provisions of the pilot program, they must be held in a securities account in order to receive the benefit of cross-margining; market participants should have the choice to have margin held in a futures account if they so desire.

[2] Cross-margining is a type of risk-based margining that jointly margins related products (securities, options and futures contracts) that are traded in different markets and generally cleared by different clearing entities.

The CBOE pilot program has similarities to the pilot program for SFPs found in Section 7 of the Senate Agriculture Committee bill insofar as the CBOE program permits portfolio margining. The CFTC urges Congress to enact legislation that will allow firms and their customers to benefit from the use of risk-based portfolio margining systems.

Clarification of Narrow-Based Security Indexes

Section 8 of S. 1566 as reported by the Senate Agriculture Committee directs the SEC and the CFTC to undertake a joint rulemaking that would exclude certain types of indexes from the definition of "narrow-based security index." In the CFMA, Congress determined that SFPs, which include "narrow-based security indexes," would be subject to joint regulation by the SEC and the CFTC. At the same time, Congress directed the SEC and the CFTC to issue rules defining both broad- and narrow-based security indexes for foreign securities markets.[3] Neither set of rules has yet been promulgated. Further, Congress, in the CFMA, provided the SEC and CFTC with the authority to exclude certain other types of indexes and instruments from the definition of "narrow-based security index."[4] The agencies have not acted to exclude certain types of indexes which we believe Congress did not intend to be regulated as SFPs. Legislation to compel a joint SEC/CFTC rulemaking in this area would be appropriate to provide legal certainty to market participants, and to give effect to the intent of Congress when it enacted the CFMA, which we understand was to make these products available to U.S. investors.

[3] See CEA Section 1a(25)(C) and Securities Exchange Act Section 3a(55)(D)(joint broad-based rulemaking), and CEA Section 2(a)(1)(E)(i) and Securities Exchange Act Section 6(k)(1)(joint narrow-based rulemaking). CEA Section 2(a)(1)(E)(ii) and Securities Exchange Act Section 6k(2) specifically require that, in promulgating rules pursuant to Sections 2(a)(1)(E)(i) and 6(k)(1), the agencies shall take into account the nature and size of the markets underlying the foreign security index.

[4] CEA Section 1a(25)(B)(vi).

The Senate Agriculture Committee bill would not cause the SEC to lose jurisdiction or alter the prior jurisdictional division between the agencies but, rather, would add needed clarification regarding the classification of these products. The CFTC has had exclusive jurisdiction over futures on broad-based security indexes, and options on such futures, for well over 20 years. These markets have operated effectively under CFTC oversight. Prior to enactment of the CFMA in 2000, approximately 100 futures contracts on broad-based security indexes—both domestic and foreign—were approved for trading by the CFTC in coordination with the SEC.[5] In the CFMA, Congress preserved the CFTC's exclusive jurisdiction over futures on broad-based security indexes. Congress provided joint jurisdiction with the SEC only over futures on single stock and narrow-based security indexes—CEA §2(a)(1)(D)—not with respect to futures on broad-based security indexes.[6]

It has been five years since enactment of the CFMA. The agencies have not adopted rules for foreign security indexes and debt security indexes because of divergent views over whether the current narrow-based security index test applies to those markets and indexes. It is appropriate at this time to provide more statutory clarity regarding what constitutes a broad-based security index. Congress should act to provide legal certainty to market participants and to regulators, and at the same time allow for innovation and competition in these markets.

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[5] See Appendix A.

[6] The SEC has explicitly acknowledged the CFTC's exclusive jurisdiction over futures on broad-based security indexes on many occasions. In 1983, an SEC no-action letter stated, "The Commodity Futures Trading Commission ("CFTC") has <u>exclusive jurisdiction over . . . futures contracts on broad-based indices of any securities</u>**.**" See Granite Fund, SEC No-Action Letter, October 31, 1983. The SEC again acknowledged the CFTC's exclusive jurisdiction more recently, in 2002, in the joint order issued by the SEC and the CFTC excluding certain security indexes from the definition of "narrow-based security index" under the CEA and the federal securities laws. The CFTC/SEC Joint Order on Grandfathered Security Indexes stated, "[t]o distinguish between security futures on narrow-based security indexes, which are jointly regulated by the Commissions, and futures contracts on broad-based security indexes, <u>which are under the exclusive jurisdiction of the CFTC</u> . . . .") (emphasis added). 67 Fed. Reg. 38,941 (June 6, 2002).

Further, we believe that the four broad-based security index definitions that we have developed are reasonable and consistent both with past CFTC practice in approving futures on broad-based security indexes, and with Congressional intent in enacting the CFMA. In brief, these definitions relate to: 1) foreign security indexes; 2) U.S. debt security indexes; 3) foreign debt security indexes; and 4) a general broad-based security index definition. These four definitions are more fully described in Appendix B.

The current statutory test for "narrow-based security indexes" is quite detailed and was tailored to fit the U.S. equity market.[7] In addition, the CFMA included a "non-narrow-based" security index test.[8] These current statutory tests for narrow- and non-narrow-based security indexes are appropriate for the U.S. equity market, which is the largest, deepest, and most liquid securities market in the world by far.

These tests were not designed to apply to foreign markets, as most of these countries do not list even 200 equity securities—let alone 675 securities as contemplated by the "non-narrow-based" test. In addition, foreign equities generally are not registered under Section 12 of the Securities Exchange Act of 1934, and so it is difficult, if not impossible, to meet the current non-

[7] The statutory test for "narrow-based security indexes" provides that an index will be considered "narrow-based" if: 1) it has nine or fewer components; 2) one of the component securities comprises more than 30% of the index's weighting; 3) the five highest weighted component securities in the aggregate comprise more than 60% of the index's weighting; or 4) the value of average daily trading volume of the bottom quartile of the index, by weight, falls below $50 million (or below $30 million in the case of indexes with 15 or more component securities). CEA Section 1a(25)(A), Securities Exchange Act Section 3a(55)(B).

[8] The statutory test for a "non-narrow-based security index" provides that a security index will be considered "non-narrow" if: 1) it has at least nine component securities; 2) no component security comprises more than 30% of the index's weighting; and 3) each component security is registered under Section 12 of the Securities Exchange Act, is one of 750 securities with the largest market capitalization, and is one of 675 securities with the largest dollar value of average daily trading volume. CEA Section 1a(25)(B), Securities Exchange Act Section 3a(55)(C).

narrow-based security index test. With regard to indexes that are currently not being offered in the United States (due in large part to the barrier to entry created by the current narrow-based security index test), CFTC economists have identified numerous well-established foreign indexes that would not meet the current test, but which should be considered broad-based under a test that more accurately takes into account the nature, size and character of foreign markets (as required by the CFMA).[9] (See Appendix C.) This point is evidenced by the clear language of the CFMA, which mandated that in developing joint foreign narrow-based security index product rules, the Agencies should consider the size and nature of the markets underlying the foreign indexes.[10]

In addition, application of the current narrow-based security index test in foreign markets results in strange anomalies. Several well-known foreign security indexes that are currently trading as broad-based indexes pursuant to the "grandfather" provision in the CFMA—the IBEX-35 (Spain); the Hang Seng (Hong Kong); the MSCI Singapore Free; and the MSCI Hong Kong—would not meet the current statutory test. This results in a situation in which existing indexes may continue to trade, but an identical new index that is required to meet the current "narrow-based security index" test could not qualify to trade. These anomalous results, and the clear language of the statute, evidence that Congress did not intend to apply the narrow-based security index test to foreign markets.

[9] Application of the current narrow-based security index definition almost certainly means that all foreign industry and sector indexes will be considered to be narrow-based.

[10] CEA Section 2(a)(1)(E)(ii), Securities Exchange Act Section 6(k)(2).

Similar difficulties occur in attempting to apply the current statutory definition to domestic debt securities. Additionally, it is very clear that Congress intended U.S. government debt to be excluded from the definition of SFPs. And the language of the CFMA indicates that Congress did not intend for foreign government debt or agency debt to be traded under the dual SFP regulatory scheme.[11] The market capitalization and quartile tests, and particularly the trading volume measures, in the narrow-based security index test are not appropriate for these markets. To illustrate this point, after passage of the CFMA, the agencies were contacted by the Chicago Board of Trade (CBOT), which wanted to increase the number of component securities (from 40 securities to 200 securities) in its existing municipal debt security index. However, the data was not available to evaluate the volume requirement of the test, and so the new (200-security) index could not pass the statutory test. This would seem to defy common sense. If the old (40-security) index contract was considered broad-based, then there is something wrong with the current definition if it will not accommodate as broad-based the same index with 200 underlying securities. The result has been a barrier to entry, such that exchanges simply do not attempt to offer futures on broad-based debt security index contracts to the marketplace.

Accordingly, a separate test is needed for domestic debt securities. And because foreign debt markets are significantly different from U.S. debt and equity markets, there also needs to be an appropriately-crafted test developed specifically for foreign debt security indexes.

[11] There is a long history of futures being offered on U.S. Treasury bonds, notes and bills at the Chicago Board of Trade (CBOT). The same can be said for futures on German Government bund, bobl and schatz, first at the London Stock Exchange, then Eurex, and most recently at Eurex US and the CBOT. There is no evidence that Congress, in enacting the CFMA, had any intention of requiring futures on these government debt instruments to be SFPs subject to joint CFTC/SEC jurisdiction, as opposed to being solely subject to the CFTC's exclusive jurisdiction. It may be appropriate at this time to consider statutory or regulatory revisions to broaden the list of exempted securities that may appropriately underlie futures contracts and be included as component securities in debt security index contracts.

The Senate Agriculture Committee bill would promote clarity in this area by requiring the CFTC and the SEC to jointly promulgate final rules within 180 days. It also provides criteria that the CFTC and the SEC are to use in excluding indexes on U.S. debt instruments, foreign equities, foreign debt instruments and other U.S. securities from the definition of "narrow-based security index." As noted above, the CFTC has developed specific definitions to address each area[12] that would tailor the rules for foreign equity markets (which are significantly smaller than U.S. equity markets) and debt instruments (which are inherently unable to meet the current volume and market capitalization tests in the statute) based on the size and nature of those markets, and on the potential for insider trading and market manipulation. Either these definitions should be codified, or joint regulations adopting such definitions should be issued. These definitions would address a significant problem, and are consistent with the language in the CFMA.

The Zelener Decision/Foreign Currency Fraud

With regard to the adverse impact of the Seventh Circuit Court of Appeals decision in the *Zelener* case on the CFTC's ability to combat retail foreign currency (forex) fraud, the CFTC continues to believe that the *Zelener* case was wrongly decided and that the contracts at issue in that case were futures contracts. We therefore urge Congress to restore legal certainty by clarifying the CFTC's jurisdiction in this area.

Retail forex fraud is a significant concern for the CFTC. In the last 4 years, the CFTC has brought 79 enforcement actions involving forex fraud against unsuspecting retail customers. In these 79 cases, there were 23,000 victims who invested approximately $350 million. Courts

[12] See Appendix B.

have awarded approximately $267 million in customer restitution and civil penalties in these cases. The Commission has been able to recover some funds for distribution to customers, but the total amount of funds frozen and/or distributed is less than $15 million.

There are divergent views over whether Congress should address the *Zelener* decision broadly with respect to all commodities, or narrowly with a "forex-only" solution. The Commission transmitted legislative language limited to forex to the Senate Agriculture Committee on May 20, 2005, and noted at the time that the legislative package "represents a consensus among the Commissioners and the minimum which the Commission believes it needs in terms of change to the Commodity Exchange Act during reauthorization."

As you may know, the staff of the PWG members met at least weekly during the month of August with respect to the *Zelener* issue. As noted in the introduction, PWG staff has reached agreement in concept on a *Zelener* solution that it believes will give the CFTC adequate authority to address the significant retail forex fraud problem.

The final details of the language are being worked out for approval by the PWG Principals. I would note, though, that the staff believes the concept would provide the CFTC with fraud authority over retail forex "futures look-alike" contracts, and thus specifically address the problem raised by the *Zelener* decision. It would address the significant problem that our enforcement staff has faced in the investigation and prosecution of fraudulent bucket shops and solicitors who prey upon retail customers in the forex arena.

The proposed language, however, would apply only to certain retail foreign currency transactions – futures and "futures look-alike" contracts as were involved in the *Zelener* case. Its scope is narrow, as it also makes clear that legitimate spot transactions (such as the purchase of foreign currency at a currency exchange) are not included within the jurisdiction of the CFTC.

The proposal also would retain the current "otherwise regulated" scheme established in the CFMA, whereby retail foreign currency transactions by financial institutions such as banks, broker-dealers and insurance companies are excluded from the CFTC's jurisdiction. The CFMA excluded these "otherwise regulated" financial institutions based on the premise that their regulators will oversee, examine and bring fraud actions if there are problems. SEC-registered broker-dealers will not be required to register with the CFTC in order to engage in off-exchange forex transactions with retail customers. They will still be able to rely upon the "otherwise regulated" exclusion in the statute, subject to the review and oversight of the SEC.

Finally, it is important to reiterate that the CFTC continues to believe that *Zelener* was wrongly decided. We believe that the foreign currency contracts that were the subject of that controversy were futures contracts, and that they were not excluded spot contracts because no deliveries of foreign currency were ever made to any customers under any of the contracts. We also note that the court in *Zelener* determined that there clearly was fraud involved. The CFTC will continue to litigate this issue vigorously to protect customers against precisely this type of fraud and abuse.

Principal-to-Principal Antifraud Authority

Section 2 of S. 1566 amends Section 4b of the CEA to address an important issue relating to the CFTC's antifraud authority. Section 4b, the CFTC's main antifraud provision, has been amended in this bill to clarify that the CFTC has the authority to bring fraud actions in off-exchange "principal-to-principal" futures transactions. These changes are necessary to eliminate significant obstacles to the use of the CFTC's antifraud authority in today's non-intermediated markets.

In late November 2000, the Seventh Circuit Court of Appeals ruled that the CFTC could use Section 4b only in "intermediated" transactions—those involving a broker-customer relationship. *Commodity Trend Service, Inc. v. CFTC*, 233 F.3d 981, 991-992 (7th Cir. 2000)(*CTS*). In other words, the court ruled that the CFTC cannot use its Section 4b antifraud authority in "principal-to-principal" transactions. Meanwhile, at about the same time, the CFMA amended the CEA to permit off-exchange futures and options transactions that are done on a principal-to-principal basis, such as energy transactions pursuant to CEA Sections 2(h)(1) and 2(h)(3). Congress specifically reserved the CFTC's Section 4b antifraud authority in Section 2(h) so that the CFTC could prosecute fraud involving transactions conducted under that Section of the CEA. Since <u>all</u> Section 2(h) transactions <u>must</u> be done on a principal-to-principal basis to qualify for the exemption, it is important to clarify that Section 4b antifraud authority applies to non-intermediated transactions. Without this clarification, the work of Congress in 2000 to protect energy markets from fraud could be rendered meaningless.

Accordingly, the Senate Agriculture Committee's reported bill amends subsection 4b(a)(2) by adding the words "or with" to address off-exchange principal-to-principal transactions. This new language would make it clear that the CFTC has the authority to bring antifraud actions in off-exchange principal-to-principal futures transactions, including exempt commodity transactions in energy under Section 2(h) as well as all transactions conducted on derivatives transaction execution facilities. This amendment to Section 4b would implement congressional intent to reserve the CFTC's antifraud authority with regard to principal-to-principal transactions.

In addition, the amended Section 4b would clarify that market participants in these transactions are not required to disclose information that may be material to the market price, rate or level of the commodity in such off-exchange transactions. It also would codify, however, existing law that prohibits market participants from using "half-truths" in negotiations and solicitations by requiring necessary disclosures to protect against materially misleading statements.

I note that the Section 4b language is supported by the Futures Industry Association, the National Futures Association, the Chicago Mercantile Exchange, the Chicago Board of Trade, the New York Mercantile Exchange, Eurex U.S., and others.

Civil and Administrative Actions under Section 9

Section 3 of S. 1566 amends CEA Section 9 by adding a new subsection 9(f) that would clarify the CFTC's authority to bring civil and administrative actions. Under Section 9 of the

CEA, it is a felony for any person to knowingly make false, misleading or inaccurate reports regarding the price of any commodity—including electricity and natural gas. Most of the other provisions of Section 9 similarly identify types of misconduct that constitute felonies. The CFTC lacks criminal powers, but it has brought civil enforcement proceedings under Section 9 throughout its history. In fact, in the last 25 years the CFTC has brought over 70 civil injunctive or administrative enforcement actions under Section 9.

In the last 3 years, the CFTC has used Section 9 to achieve approximately 30 significant monetary settlements, totaling nearly $300 million in civil monetary penalties, for "false reporting" by energy trading firms or their traders in violation of CEA Section 9. In many of these cases, the energy trading firms or their traders reported a very large number of fictitious transactions, or reported significantly altered data about transactions, to publications that compile and publish natural gas price indexes. The false reporting was done in an attempt to manipulate index prices.

Energy firms and traders have argued that the reporting of fictitious transactions and significantly altered data about transactions is excluded from the CFTC's jurisdiction by Section 2(g) of the CEA. The CFTC has consistently taken the position that, even if a transaction is excluded from CFTC jurisdiction under Section 2(g), the false reporting of such a transaction is a separate act that remains a violation of Section 9 that the CFTC has authority to prosecute. On August 1, 2005 the CFTC's position regarding false reporting and the scope of the exclusion under Section 2(g) (and the related exemption under CEA Section 2(h)) were upheld in *CFTC v. Bradley*, Case No. 05-CV-00062-JHP-FHM (N.D. OK Aug. 1, 2005). This is the first reported decision in this area, and an extremely important one that affirms the CFTC's authority and ability to prosecute false reporting cases under CEA Section 9.

Even with the *Bradley* decision, we feel a legislative change to Section 9 is still necessary because it would clarify the CFTC's authority to bring civil and administrative actions, and would ensure that the CFTC can continue to bring false reporting cases in the energy arena for acts or omissions that occurred prior to enactment. The Senate Agriculture Committee bill expressly provides that these amendments restate, without substantive change, existing CFTC civil enforcement authority. This clarifying change does not grant any new statutory authority, and provisions of Section 9, as restated, continue to apply to any action for any alleged violation occurring before, on, or after the date of enactment.

Section 3 of S. 1566 also amends CEA Section 9 to double the civil and criminal penalties available for certain criminal violations of the CEA such as manipulation, false reporting, and conversion. The maximum fines under Section 9 would be increased from $500,000 to $1 million, and the maximum prison sentence would be increased from 5 to 10 years. In a similar vein, Section 3 of S. 1566 includes conforming amendments to the procedural enforcement provisions in Sections 6(c), 6b, and 6c of the CEA to effectuate this increase in civil monetary penalties.

I note that the Section 9(f) statutory language is consensus language that has been agreed to by the Futures Industry Association, the Chicago Mercantile Exchange, the Chicago Board of Trade, the New York Mercantile Exchange, Eurex U.S., and others.

Conclusion

The CFTC's reauthorization is a unique opportunity to address the five areas that I have mentioned: portfolio margining for security futures products and security options; clarification of definitions applicable to broad-based foreign security indexes and debt indexes; the *Zelener*/forex fraud provision; the CEA's principal-to-principal antifraud authority; and increased penalties and clarification of civil and administrative authority. The CFTC is eager to work with the Congress to successfully complete reauthorization of the CFTC this year. Thank you for the opportunity to testify on these important matters.