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COMMODITY FUTURES TRADING COMMISSION

PUBLIC HEARING ON EXEMPT COMMERCIAL MARKETS

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P R O C E E D I N G S

(9:05 a.m.)

CHAIRMAN LUKKEN: Good morning. It's a pleasure for me -- me and my fellow commissioners -- to welcome you today to a hearing on exempt commercial markets. I would like to thank all distinguished panelists for being here to share their views and expertise with the Commission.

I would also like to welcome several members from Capital Hill who have covered these issues and have helped advance this debate. Thank you for coming.

The proper regulation of the nation's energy markets is one of the most significant issues facing this Commission. Energy prices discovered on these markets greatly impact our economy and every American ranging from residential consumers to main street businesses to Wall Street firms.

It is this Commission's mandate to ensure that our energy markets remain free of price distortions and fraud. Recent hearings before Congress have highlighted concerns that these markets are subject to abuse and not adequately reflecting the fundamentals of supply and demand. Whether this perception has a basis in fact is the subject of today's hearing, but regardless, this doubt is troublesome because it could keep potential users from managing risk or benchmarking prices in these markets. This should be of primary concern as we scrutinize the regulatory framework of these markets today.

In 2000 Congress created a tiered regulatory structure for the futures markets with the passage of the Commodity Futures Modernization Act, which attempted to tailor regulated requirements to specific risks of the marketplace. This calibrated structure has provided regulators with the proper flexibility and focus as we strive to keep pace with this industry's global growth.

One cannot argue with the success of the U.S. futures industry as demonstrated by its four-fold growth since the CFMA's passage as well as its growing global market share. Within their tiered design, Congress created a light touch regulatory category called Exempt Commercial Markets, or ECMs, on which certain commodities such as energy could be traded by institutional participants. Due to the nonretail nature of these markets and their modest beginnings, policymakers believed that the risks associated with these institutional exchanges to be low.

However, the energy markets have changed dramatically in these seven years, and this Commission's regulation of these markets should evolve in kind. Although these exempt markets have increased competition and lowered costs for derivatives trading, certain ECMs now function as virtual substitutes to regulated exchanges with tight correlation and linking of prices.

Today, the Commission will reexamine the legal and regulatory structure of these markets, noting meaningful similarities and distinctions. In addition to the testimony of effective groups, we will first hear from CFTC staff who will report on their extensive interviews with market participants and their economic analysis on the price discovery functions of ECMs.

This broad range of discussions will be valuable as the Commission aims to complete the evidentiary record and provide timely findings to Congress. In doing so, we must remain true to the risk-based philosophy of the CFTC and be mindful of any potential impact we would have on the competitiveness of these global electronic markets.

But the heart of the debate will turn on whether the Commission has the proper tools to uphold its core mission to ensure that these markets are fair, open, and transparent, free from manipulation and fraud. This will be our primary focus today.

We look forward to hearing from our distinguished witnesses, and I now turn to Commissioner Dunn for his opening remarks.

COMMISSIONER DUNN: Thank you, Mr. Chairman, and I wish to commend you for having these hearings today. Back in July when we were in front of the PSI on a hearing, you committed to a fresh look at what was needed in the market, and the swift act and the action that you have taken exhibited here today is very commensurate. Thank you very much.

Over the last two years I've had the opportunity to meet with a wide range of audiences regarding regulation of the derivatives market. I've been struck that the basic thing people desire is simple: They want to have confidence that the game is to rigged.

Events such as the alleged recent manipulation by Amaranth in the natural gas markets, the alleged manipulation of propane markets by BP, the proven manipulations of Enron have led the public to question the integrity of the derivatives market and ask, who is in charge? Well, when it comes to energy derivatives market, the answer seems at times to be no one.

We have people on tape and in emails boasting that they can get away with gaming the market because no one is watching them. While the

Commission aggressively pursues market manipulation that comes to its attention, in the absence of a regulatory structure of accountability and transparency, manipulative behavior may go undetected.

The central problem is that the CFMA seems to have placed a large swath of energy derivative markets beyond key elements of the CFTC jurisdiction.

We have to consider today whether this makes sense and what tools are necessary to safeguard energy markets we regulate from fraud and manipulation. Things have certainly changed since the Passage of the CFMA.

Recent hearings and past legislative battles on Capital Hill have shown there are significant concerns among members of Congress and the general public regarding exempt commercial markets. I know there are a lot of different legislative proposals for fixing the problems potentially created by 2(h)(3).

I think the question we need to explore

is whether and how 2(h)(3) is flawed. I think we need to think carefully about how it fits with the larger structure of the CEA and, most importantly, I think we need to consider how to best provide the openness and transparency the public demands and deserves when it comes to its energy futures markets.

Once again, I thank you, Mr. Chairman, and I thank those that are participating today.

CHAIRMAN LUKKEN: Thank you, Commissioner Dunn.

Commissioner Sommers?

COMMISSIONER SOMMERS: Thank you. Good morning. I want to join Commissioner Dunn in commending you, Commissioner Lukken -- Chairman Lukken -- for holding this important hearing, and I also want to thank all the Commission staff for all their hard work in organizing today's events.

As one of the newest members of the Commission, I'm grateful for this opportunity to learn more about the evolution of trading on exempt commercial markets and the integration between ECMs and designated contract markets, especially with respect to energy trading. The markets that the Commission oversees play a vital role in the price discovery process for natural gas, crude oil, and other energy products.

A critical component of our mission is to detect and to deter manipulation of those prices. Energy trading on DCMs and ECMs has grown exponentially since the Commodity Futures Modernization Act was passed almost seven years ago.

I think it is appropriate for the Commission and for Congress to examine whether the regulatory structure that was put into place then remains effective in protecting the integrity of the markets and fostering innovation today.

One of the many recent developments in this area is the linkage between certain contracts traded in ECMs and contracts traded on DCMs. Questions have also been raised about the role of speculation in both marketplaces. It is important to determine whether the Commission has the tools it needs to police these markets effectively and to ensure a level regulatory playing field.

It is also important that we keep the global competitiveness of the U.S. markets in mind when considering how to address any gaps or imbalances that may have arisen. These are complex issues that deserve thoughtful and careful deliberation.

I want to thank all the panelists for agreeing to participate in the discussion today, and I look forward to hearing their views and learning more about these important markets.

CHAIRMAN LUKKEN: Thank you, Commissioner Sommers.

Commissioner Chilton.

COMMISSIONER CHILTON: Thank you, Mr. Chairman, and thank you and Commissioner Dunn for holding this place together by yourselves for such a long time before Commissioner Sommers and I showed up at the jobsite, and thanks for holding this hearing.

I think it is important and I hope we

will have the others in the future. People have said to me that there are myriad issues that they'd like to see other hearings held on. Everything from carbon trading to event futures. Whether or not the CFTC will ultimately regulate election result futures or the next Oscars is a question that, as they say, inquiring minds want to know. So I hope we have future hearings as issues warrant.

CHAIRMAN LUKKEN: Not today.

COMMISSIONER CHILTON: I was in Senator Feinstein's office not too long ago talking with her about this issue, and I have got to commend her for really having foresight on this issue years and years ago. The rest of us are merely trying to sort of catch up and get to where she's been.

And likewise, Senator Levin and Senator Coleman have, I think, done a great service with the PSI hearing, bringing this issue to the forefront, and, as Commissioner Sommers said, the linkage between the regulated and nonregulated energy markets. So I'm hopeful that Congress is at a place where they may be able to do something on this issue in the not too distant future.

The Commodity Exchange Act, as we all know we operate under here in this building, allows us or gives us the oversight authority, rather, and the jurisdiction -- the jurisdiction over risk management markets. And in so doing, they give us three basic constructs that we are supposed to adhere to, goals if you will.

We're supposed to protect price discovery, we're supposed to guard against manipulation, fraud and abuse, and we're supposed to try to ensure that these markets for futures and options operate in a way that's viable, effective, and efficient not only for hedgers and speculators but for consumers, for consumers as well.

And it makes it really difficult for us to achieve those goals when we have these look-alike energy markets that are operating in the dark which aren't subject to the rules and regulations of the Commission. So I'm really hopeful that something can be done so that we can move forward, and I think that we can. I think Congress will take this up.

And the important thing is that when they do that, that they do so as to keep in place this principles-based regulatory regime that we have that is so unique to this agency. The SEC doesn't have it, USDA doesn't have it, nobody else has it. This principles-based regulatory regime is really different from this top-down prescriptive regulatory structure that everybody else has.

We're not your fathers' regulators, and it is good that we aren't because it allows this industry to move forward. It allows the agency to see around the corner, to be nimble and quick, and to in real time make decisions about changes or potential changes that may happen be they positive or negative. And at the same time this principles-based regulation fosters the growth in this whole industry, the U.S. futures industry, to this rapid growth that Chairman Lukken talked about contributes to the economic engine of our democracy, and we're better for it.

So I think the good government response to this issue isn't to sit back and wait for some economic calamity to occur; I think we've seen with Enron and Amaranth, and with British Petroleum the problems that can occur. And, for me, it is not a question of if we do it: It is how Congress does this.

And so I'm really appreciative of all the witnesses being here today. It is important. I know everybody doesn't agree with me -- that's okay, that's what this is about -- but I'm really appreciative that you've all here with us. I look forward to hearing your comments. And today, Mr. Chairman, I'll be an inquiring mind.

CHAIRMAN LUKKEN: Thank you, Commissioner Chilton. I just want to welcome all the new commissioners as well. It is nice to have more faces up here and a diversity of views, and it helps us to reach good decisions. I appreciate everybody being here and now having our first hearing, public hearing.

With that, I wanted to lay out a bit of the agenda, some logistics for today. We are going to have two panels in the morning, two panels in the afternoon with a break at lunch. There won't be any other breaks between panels. If everybody could turn off cell phones and blackberries -- they interfere with microphones -- we'd appreciate that as well.

With that we will hear from all of our witnesses on a panel and reserve questions till the end of the panel's testimony. So we'll hear all the panel's testimony before we ask any questions.

And with that, I'd like to introduce our general counsel, Terry Arbit, who will begin the proceedings. Welcome, Terry.

MR. ARBIT: Thank you, Mr. Chairman, Commissioners. My name is Terry Arbit, and I am General Counsel of the Commodity Futures Trading Commission.

I've been asked to help frame the

discussions at today's hearing by providing an overview of the statutory structure for derivatives markets under the Commodity Exchange Act, which we call the CEA, and describing how exempt commercial markets fit into that structure. Along the way, I'll identify some common misperceptions regarding the legal environment in which exempt commercial markets currently operate.

As the Chairman noted, in the Commodity Futures Modernization Act of 2000, the CFMA, Congress established a tiered approach to regulatory oversight of derivatives markets. Each tier is subject to a varying level of oversight based primarily on the commodity traded, the type of trading, and the nature of the participants in the market.

Among futures markets, the designated contract market occupies the top tier representing what is often described as a fully-regulated futures exchange. A contract market may trade contracts based on any commodity, and may offer products to retail customers on an unrestricted basis. Under the CFMA's principles-based oversight regime, contract markets are afforded significant flexibility in how they run their operations but, nonetheless, must initially satisfy specified designation criteria and thereafter must demonstrate compliance with comprehensive core principles on an ongoing basis.

The CFMA also created a new category of futures exchange called the Derivatives Transaction Execution Facility, or DTEF. There are two types of DTEF, a retail DTEF and a commercial DTEF. Both DTEF categories have fewer regulatory requirements than a contract market, but they're subject to differing limitations on eligible traders and the commodities that may be traded.

Although subject to a lighter regulatory regime, this alternative exchange must have compliance and surveillance programs and must undertake significant self-regulatory responsibilities. To date, no trading facility has applied to the Commission to register as a

DTEF.

The CFMA also created a broad and complex array of exclusions and exemptions from regulation for certain derivatives products that are traded over the counter either bilaterally or on electronic trading facilities. These exclusions and exemptions reflect a view consistent with various congressional and Commission actions during the preceding decade that off-exchange transactions between sophisticated counterparties, do not necessarily require the full weight of the protections that the CEA provides for contract markets and DTEFs.

One such exemption which we are gathered to discuss here today is for transactions in exempt commodities on electronic trading facilities that are known as exempt commercial markets. Exempt commodities generally include commodities such as energy, metals, chemicals, and emission allowances.

It is sometimes said that exempt commercial markets are unregulated, but that is not quite right.

Although largely exempt from Commission oversight authority under the CEA, Congress did subject exempt commercial markets to a limited set of regulatory requirements under Sections 2(h)(3) through (5) of the statute. The Commission has implemented these requirements in its Rule 36.3.

In recent years, derivatives trading on certain exempt commercial markets has grown substantially due in no small measure to the regulatory environment created by the CFMA. At the same time exempt commercial markets have evolved in ways that may not have been anticipated when the CFMA was enacted.

The question arises, therefore, whether the regulatory line for exempt commercial markets that was drawn by Congress and the CFMA remains appropriate today. That is, on the regulatory spectrum ranging from no regulation of bilateral, over-the-counter transactions on the one hand to fully-regulated futures exchanges on the other hand, should policymakers adjust that line governing exempt commercial markets further along the spectrum toward the degree of regulation that is applicable to contract markets and DTEFs?

With that background, let me now discuss how exempt commercial markets are regulated under the CEA.

First, market participants: Exempt commercial markets are electronic trading facilities that restrict trading to principal-to-principal transactions between eligible commercial entities. That term "eligible commercial entities," like the name "exempt commercial markets" itself, connotes a purely commercial marketplace among entities that can make or take delivery of the underlying commodity. But that also is not quite right.

Under the statutory definitions of the CFMA, pooled investment vehicles such as hedge funds qualify as an eligible commercial entities and their participation on certain exempt commercial markets has become both active and significant.

Second, regulatory requirements: Exempt commercial markets are subject to certain record-keeping and reporting requirements under the CEA. The statute requires that an exempt commercial market maintain for five years and make available for inspection upon request by the Commission records of its activities related to its business as a trading facility.

More specifically, under Rule 36.3 an exempt commercial market must identify to the Commission those transactions which averaged five trades per day or more over the most recent calendar quarter. For all such transactions the exempt commercial market must provide to the Commission weekly reports showing certain basic trading information or provide the Commission with electronic access that would allow the Commission to compile that same information.

The CEA also gives the Commission the authority to require an exempt commercial market to provide upon special call information relating to its business as the Commission may determine appropriate to fulfill certain specified statutory mandates.

The Commission staff has issued several special calls to the Intercontinental Exchange, an exempt commercial market generally referred to as ICE, requesting information on trader positions in ICE natural gas contracts that are directly linked to NYMEX futures prices. The purpose of these special calls was not to surveil ICE, as the Commission has no statutory authority to do so. Rather these special calls were issued to support surveillance of the NYMEX natural gas contracts.

The Commission has imposed one further record-keeping requirement on exempt commercial markets in its Rule 36.3. That rule requires an exempt commercial market to maintain a record of allegations or complaints that it receives concerning suspected fraud or manipulation and to provide the Commission with a copy of the record of each complaint that alleges facts that would constitute a violation of the CEA or Commission regulations.

Third, some of the differences between exempt commercial markets and contract markets: Though exempt commercial markets are subject to these limited regulatory requirements, the CEA does not subject them to the level of transparency and Commission oversight associated with contract markets. The contract markets must demonstrate compliance with core principles on a continuing basis. These core principles require regulated futures exchanges to undertake significant supervisory responsibility with respect to trading on their markets.

For example, contract markets must have rules and procedures for preventing market manipulation. They are required to adopt position limit or accountability rules in order to address the potential for market manipulation or congestion, and contract markets must have compliance and surveillance programs which the Commission evaluates through its rule enforcement reviews.

These statutory requirements do not

apply to exempt commercial markets which are not required under the statute to monitor trading on the facility. Nor does the Commission have the same authorities to address problems on exempt commercial markets as it does for contract markets.

For example, the Commission's statutory emergency authority and its authority to force a reduction or liquidation of positions, and to alter or supplement the trading facility's rules do not extent to exempt commercial markets.

The CEA does provide that the Commission may determine that an exempt commercial market performs a significant price discovery function for transactions in an underlying cash market. Such a determination does not trigger additional self- regulatory responsibilities or additional oversight authority for the Commission. Rather, it triggers an obligation by the exempt commercial market to publicly disseminate certain specified information regarding contract terms, volume, open interest, and prices.

Finally, let me say a word about the Commission's antifraud authority over transactions on exempt commercial markets. In November of 2000, the 7th Circuit Court of Appeals suggested in the CTS case that Section 4b of the CEA, which is the Commission's primary antifraud tool, is limited to intermediated transactions, that is, those that involve a broker. As part of its reauthorization process in Congress, the Commission has proposed an amendment to Section 4b, the terms of which have been agreed to by the various sectors of the futures industry. This important legislative amendment would clarify the Commission's authority to bring fraud actions involving the principal-to-principal transactions that occur on exempt commercial markets.

And now with the summary of the statutory structure for derivatives markets in mind, let me turn it over to my colleagues for discussion of the Commission's work with respect to exempt commercial markets in practice.

Thank you.

CHAIRMAN LUKKEN: Thank you, Terry. Now we're going to turn to our Director of the Division of Market Oversight, Rick Shilts, who will give us an overview of his division and what they do in this area. Thank you, Rick.

MR. SHILTS: Thank you, Mr. Chairman. Good morning, participants. As you said, my name is Rick Shilts, and I'm the Director of the Commission's Division of Markets.

The Division's primary mission involves oversight and surveillance activity on the regulated futures exchanges called contract markets or DCMs. The Division also carries out the requirements of the law related to exempt commercial markets or ECMs.

I'd like to start out by providing some background information on the EMCs that are filed and noticed to date. As was described by Terry Arbit, our general counsel, the EMC category was created by the CFMA in December of 2000. Two of the first facilities to file notices in 2001 were the International Maritime Exchange, or IMAREX, and Norwegian market trading freight rates and the Intercontinental Exchange in Atlanta, also known as ICE, trading energy products.

From 2001 to now a total of 20 companies have filed notifications to operate as an exempt commercial market. Just in the past year, we received three new ECM filings. In addition, our staff is currently in contact with several other companies who are actively contemplating filing formal notifications.

Not all ECMs are successful. Currently, only eight of the twenty ECMs that have filed a notice are active; the others have gone out -- have either gone out of business or have been acquired by another ECM. Some have not yet commenced operations.

Of the 20 EMCs that have filed a notice, many trade or plan to trade energy-related products, mostly natural gas, petroleum products and electricity. Other commodities that have been listed or intended for trading on ECMs include emission allowances, metals, freight rates, chemicals, uranium, fertilizers, pulp and paper products, and liquified petroleum gas.

The largest ECM in terms of trading volume and number of contracts traded is the Intercontinental Exchange which, as I noted, was one of the first DCMs to file the notification. ICE operates an ECM as well as regulated futures exchanges in the U.S. and the U.K.

The principal contracts listed on ICE's ECM are in the energy area, especially natural gas and electricity, and since acquiring Chem-Connect in July of this year, another active ECM, natural gas, liquids, and chemicals. The other active ECMs currently in operation include the Natural Gas Exchange, or NGX, Net Through-Put, Houston Street Exchange, IMAREX, as I mentioned, the Chicago Climate Exchange,ICAP Electronic Trading Community, and ICAP Commodity and Derivatives Trading System.

Five of the eight active ECMs offer clearing services, including ICE. Formerly, ECMs did not offer a clearing component, initially;

they generally did not provide a clearing service until they reached some level of success or threshold level of activity. This approach seems to have changed recently as newer ECMs contemplate offering clearing at start-up. In this regard, three of the ECMs filing a notice in the past year indicated a plan to offer clearing services at start-up.

In discussions with new ECMs, our understanding is that the reduced regulatory burden compared to contract markets and DTEFs is a key reason why companies choose to operate in this regulatory tier. They view the reduced regulatory burden as being more consistent with their business operations and goals. In this regard, for many ECMs the majority of their business comes from the nonregulated OTC world, including institutional traders. Becoming an ECM allowed them to expand into electronic trading under a relatively less formal and demanding regulatory scheme. For many, it does not appear that the ECM route is viewed as a first step into eventually becoming a regulated exchange.

I'd like now to offer a few observations regarding the evolution of ECMs since the CFMA was adopted in 2000. Initially, ECMs generally were bare-bones trading platforms. In many ways they were akin to business-to-business facilities for large commercial firms. Their key role was to facilitate the execution of trades between commercial counterparties by offering an anonymous and efficient electronic matching system. The ECMs believed that their electronic systems were superior to the existing voice broker system and gave them a competitive advantage in the bilateral OTC market, especially in the energy space.

The first ECMs did not offer a clearing component; they addressed issues related to the financial integrity of transactions by setting up credit filters that allowed traders to limit their counterparties to a customized list of traders. In addition, ECM participants were primarily commercial traders, and most DCMs were start-ups or relatively small operations. Initially, ECM trading volumes were small relative to volumes on the regulated futures exchanges.

Finally, early ECM contracts were generally, not directly, linked to regulated futures markets and did not affect the Commission's oversight of activity on the regulated exchanges.

In recent years, we've witnessed a number of changes in the ECM landscape. Today, while there continue to be small ECMs, many of which are start-up ventures, we also see some ECMs that have taken on many of the characteristics of regulated futures exchanges.

These ECMS are not just a forum for efficient trade execution, they now offer benefits and features in response to the needs and demands of their participant traders. A significant change is that some of the most successful ECMs and many of the newer ECMs now offer or plan to offer a clearing component that is widely utilized by their participants as an efficient and effective way to manage credit risk.

In addition, some ECMs have become major trading venues for particular commodities, especially for natural gas and electricity. There have also been changes in the types of traders that participate on ECMs. In this regard, certain exchange floor brokers and floor traders now are considered eligible commercial entities, or ECEs, and thus they can participate on ECMs.

Also, the trading communities on ECMs now includes many noncommercial traders such as large hedge funds which constitute a significant part of the overall activity and open interest in certain ECM contracts.

Another consideration is that some of the ECMs link their contracts to the prices of related contracts on the regulated contract markets. This feature has created certain complications for our staff in carrying out the Commission's mandate to oversee the futures markets. Of special concern is that the existence of cash-settled, look-alike contracts could provide an incentive to manipulate the settlement price of the underlying regulated contract market price in order to benefit from positions in the look-alike ECM contract.

In view of these developments, certain large ECMs now seem to resemble the regulated futures exchanges with respect to certain products that they trade. For example, with respect to these actively- traded cleared products, both the regulated exchanges and the large ECMs provide a forum for traders to execute transactions on a many-to-many multilateral platform.

For both markets the same types of traders are active participants, both markets employ the same types of settlement features, both types of markets offer a clearing function as an effective way to manage counterparty risk, and, finally, certain of the derivative products offered by both the regulated contract markets and the ECMs provide the same economic benefits; that is, hedging or risk management or serving as a source of price discovery for industry participants.

Recognizing these similarities, there have been indications that some ECMs might be willing to accept a certain level of heightened CFTC oversight with respect to certain types of products. In addition, we understand that the physical commodities markets have been a topic of interest in other jurisdictions.

For example, the European Commission is considering whether to maintain an exemption from various reporting and prudential requirements for certain commodity traders, including large energy companies. The European Commission recently conducted a survey on this issue and reported that certain regulatory authority may be appropriate.

As Terry discussed, under the Commodity Exchange Act, the Commission staff does not directly surveil or monitor trading activity on ECMs on an ongoing basis as it does for the regulated contract markets. As he also noted, the CEA sets forth several basic oversight provisions applicable to ECMs, including a price discovery provision.

I'd like now to talk a little more about this price discovery requirement. Specifically, the law provides that ECMs shall disseminate price, trading volume and other trading data if the Commission determines that the ECM performs a significant price discovery function for transactions in the cash market. This provision is contract- specific and, if triggered, requires dissemination of data with respect to the particular contract that has been found to perform a price discovery function.

In 2004, the Commission issued regulations stating what constitutes being a price discovery market for this purpose. Specifically, under the CFTC regulations, an ECM contract is a price discovery market if, 1) cash market bids offers or transactions are directly based on or quoted at a differential to the prices generated on the market on more than an occasional basis; or 2) the ECM's prices are routinely disseminated in a widely distributed industry publication and are routinely consulted by industry participants in pricing cash market transactions.

It should be noted that the statutory price discovery provision is somewhat circular. In this regard, the statute mandates dissemination of trading data if an ECM performs a significant price discovery function for the underlying cash market. But the underlying cash market could not be relying on the ECM contract for price discovery unless such data were already being disseminated in some form.

The Commission acknowledged the apparent circularity of the test in the price discovery criterion but noted when it adopted it is rules that the rule will ensure that the trading data is disseminated as Congress intended.

The Commission has not, under its rules to date, issued a formal price discovery determination with respect to any ECM contracts; however, in connection with this hearing our staff conducted a number of interviews with market participants to learn more as to how they trade natural gas and electricity and whether ICE prices are used as a basis for price discovery for these commodities.

I should note that price discovery is not a defined term in the Commodity Exchange Act or in the economics profession, and the term may mean different things to different people. Our chief economist will talk about this in a few minutes.

Most traders and voice brokers express the view that ICE is a price discovery market for certain natural gas and electric markets. For example, with respect to the Henry Hub Natural Gas Market, market participants generally view ICE and NYNEX as essentially a single market. Traders look to both ICE and NYNEX when determining where to execute a trade at the best price. They stated that both marketplaces offer liquid and financially secure contracts. Traders take positions in a NYMEX physically-delivered or a NYMEX cash-settled contract or in an ICE look-alike swap, depending on where they can get the best price.

For natural gas trades at locations other than the Henry Hub, market participants told us that ICE prices are widely consulted by the industry, especially for contracts involving gas at certain specific locations in the western U.S.

For certain electricity markets, traders indicated that ICE prices and indexes are widely consulted before executing a trade. Ice prices are consulted more regularly than NYMEX because NYMEX has not gained significant volume in the electricity space.

As noted, Commission regulations provide that an ECM contract is a price discovery market if cash trades are directly based on the ECM prices or if its prices are disseminated in industry publications and routinely consulted by the industry.

While market participants generally have expressed the view that ICE prices are widely consulted and utilized by the industry, for many natural gas and electricity markets, we have not yet concluded that ICE natural gas or electricity contracts meet all of the specific requirements outlined in the Commission's price discovery regulations. Our staff continues to gather more information about this issue.

I should further note that staff also is reconsidering whether the Commission's price discovery criteria remain appropriate. For example, since adopting the price discovery regulations, some ECM contracts that are linked to the prices of a regulated futures market have developed significant open interest and commercial participation. Since this feature was not previously contemplated, the Commission may wish to consider other market characteristics that would cause an ECM contract to be classified as a source of price discovery for t he cash market.

As mentioned, our discussions with industry participants indicate that traders regularly consult ICE prices in making trading decisions and that they view ICE and NYMEX as essentially one market for Henry Hub natural gas futures with price formation occurring in both markets. It appears that when two markets are linked in this way, both markets may constitute a price discovery market for the commodity in question, as it is difficult if not impossible to split the two and assign the price discovery role to a single marketplace.

Recognizing this, it may be appropriate for the Commission to reconsider its price discovery criteria to include an additional standard for linked markets.

That concludes my remarks. I will now turn it over to our chief economist who will discuss the work of his office on the issue of price discovery and other matters.

Thank you.

CHAIRMAN LUKKEN: Thank you, Rick. We now turn to Jeff Harris, who was recently announced to be the Chief Economist here at the CFTC. We stole him from the University of Delaware, but he's no stranger to our world, having consulted at the CFTC for a year or two, actually, before coming on board. So a very distinguished economist, and we welcome you.

So thank you, Jeff, and we look forward to your testimony.

MR. HARRIS: Thanks, Walt, and thank you members of the Commission. I am pleased to be here today to have the opportunity to testify on behalf of the Office of the Chief Economist, and I appreciate the opportunity to discuss related issues in the oversight of designated contract markets and exempt commercial markets.

Our office works closely with the Division of Market Oversight in providing analysis and advice on matters that relate to the oversight and examination of trading in futures markets. In preparation for today's hearing, OCE staff have collected and analyzed data that may be useful to the commissioners in evaluating the Commission's oversight of DCMs and ECMs.

As economists, we view the oversight of markets to include many dimensions of the trading process. All successful markets bring participants together with healthy futures markets allowing for rich interactions between participants aiming to manage risk and participants willing to assume price risks.

As my colleague Rick Shilts from DMO has touched upon, futures markets are also characterized by some level of price discovery. For the sake of today's hearing, OCE has examined both of these dimensions from an economic point of view. We have examined the mix of hedgers and speculators in a number of markets with an eye on whether the existence of ECM trading appears to influence this mix. We've also studied the economic process of price discovery in various markets with an eye toward whether and how much price discovery occurs on ECMs.

Futures markets of all types have witnessed an explosive growth in a trading volume during the last few years. Futures volume has more than quadrupled, and the number of actively traded contracts have more than quintupled since 2000. Accompanying this growth in exchange trading has been a parallel growth in trading activity on ECMs.

The number of firms filing notifications to operate ECMs has now grown to the current 20 from just three in 2001. The largest ECM based on trading volume in the number of contracts traded is the Intercontinental Exchange, or ICE, which is most active in trading natural gas and electricity futures. Since ICE is the most active of all ECMs, our economic analysis that relies on data focuses largely on ICE and natural gas markets in particular.

One aspect of trading that we have examined pertains to the mix of hedgers and speculators in these markets. Through data provided by DCMs, the large trader reporting system, we are able to characterize the mix of traders in these markets over time. We can monitor the mix of traders in DCMs during the time period that ECM trading volume has been growing.

Figure 1 below displays the mix of traders in NYMEX natural gas contracts from July 2004 through July 2007, a time frame that coincides with significant growth in the ICE natural gas trading. As shown in Figure 1, commodity swap dealers and managed money traders, including hedge funds, have shown the greatest growth in natural gas trading futures on NYMEX. In fact, the growth in noncommercial trading, largely speculative trading, has grown from 42 percent to 52 percent of the market from July 2004 to July 2007.

Overall we see that the mix of traders on NYMEX remains relatively stable during a period of dramatic growth of trading on both NYMEX and ICE.

To look more specifically at changes that are occurring in the natural gas market, OCE has compiled similar statistics -- see Table A below -- for active contracts in other markets: Corn, heating oil, and crude oil.

Table A suggests that the pattern of changes in the market share by noncommercial speculative traders in natural gas are broadly consistent with the patterns of changes in these other markets. Noncommercial trading interest has been rising across the board with both managed money traders and nonreportable traders driving this increase in all markets.

In this light, the changing composition of traders on NYMEX natural gas futures trading from 2004 to 2007 likely reflects in large part a market- wide trend toward greater noncommercial trading. In light of this evidence, the growth in trading of natural gas futures on ICE does not appear to be a factor in the changing composition of traders in the natural gas market.

In the economist's view, price discovery is a process by which new information is impounded into prices. Keeping in mind that this view differs somewhat from the statutory definition of price discovery, I believe our office can also provide evidence that can be used to examine similarities and difference between DCMs and ECMs along this dimension. We have, in fact, conducted an economic analysis of price discovery for trading in the natural gas futures markets where contracts are concurrently traded both on the NYMEX and ICE.

We collected transaction prices from each market from January 3, 2006, through December 31st of 2006 and evaluated trading for 20 contracts when trading on each market was appropriately active. Since the economist thinks of price discovery as the impounding of new information into prices, we examine the timing of prices changes on ICE and NYMEX to draw inferences about where information might arrive first. If the price changes on one venue consistently lead those on another venue, we may conclude that the informed traders prefer trading on the leading exchange. A market that consistently leads is said to be discovering prices.

Figure 2 here below presents a simplified visual depiction of our economic notion of price discovery, tracing prices over time. As depicted here at the box on the left, during the first part of the time period, ICE prices appear to lead NYMEX prices (by at most a minute) as natural prices begin to fall.

By contrast, the box to the right here shows during the later part of the time period, NYMEX prices appear to lead the ICE prices as natural gas prices fall further.

By following price changes in both of these markets over the entire trading day, we as economists can statistically discern which market leads the other on each trading day. We calculated price discovery statistics for each of the 1,265 contract days for our sample to quantify the degree of price discovery for ICE and NYMEX in natural gas contracts.

As might be expected from the example in Figure 2, on some days both markets might lead the other at different times during the day. In addition, on some days we are unable to discern whether either market might lead the other.

Overall, however, we find that ICE significantly leads NYMEX on 20 percent of our contract days. For comparison NYMEX significantly leads ICE on 63 percent of contract days. These results appear to suggest that in an economic sense, ICE and NYMEX are both significant price discovery venues to natural gas futures contracts.

On that note, I'll turn it over to my colleagues from Market Surveillance, John Fenton.

CHAIRMAN LUKKEN: Thank you, Jeff. We now turn to John Fenton, our head of Surveillance here at CFTC. I look forward to your testimony, John. Thank you.

MR. FENTON: Thank you, Chairman Lukken and commissioners. I'd like to welcome our guests as well, and I'm looking forward to the discussions as they proceed today.

My name is John Fenton. I am the Director of the Commission's Market Surveillance Program. This program's primary mission is to deter and prevent price manipulation or any other distortion to market integrity on regulated futures markets -- that is, designated contract markets.

I am pleased to have this opportunity to talk a bit about how we do surveillance on futures markets and, in particular, what we have been doing in energy futures markets.

While the Commodity Exchange prohibits manipulation, it does not specifically define it. This omission is a recognition by Congress that a precise definition would almost certainly fail to capture the complexity and variety of potential manipulative behavior.

It has been through the development of case law under the Commodity Exchange Act that the elements of a definition of manipulation have emerged. At the risk of oversimplification, I think a general definition of manipulation is that it is any market behavior that is intended to cause, and that succeeds in causing, an artificial price. Of course, this raises the question, what is an artificial price?

An artificial price is a price that does not accurately reflect the legitimate market forces of supply and demand. In other words, it is a price that is an artifice intentionally created by the manipulator that otherwise would not exist.

Although the elements of manipulation have emerged through cases brought by our Division Enforcement, they are also extremely relevant to how we conduct surveillance to deter and prevent manipulation. For example, the ability to cause a manipulation may stem from a dominant futures positions and, as I will discuss more fully in a few minutes, to counter this potential threat we monitor futures market positions on a daily basis.

Before proceeding, I should mention that my comments are specifically related to the scope of the Commission's market surveillance program to deter and prevent manipulation on designated contract markets, those markets described in Terry Arbit's testimony as "fully-regulated" exchanges. The Commission's authority to bring antimanipulation enforcement actions clearly extends more broadly than this, to include, for example, manipulative activity in cash markets and on exempt commercial markets.

Futures contracts are of two general

types depending on how they are ultimately settled, either through physical delivery or through cash settlement.

In both cases, the settlement mechanism is meant to ensure that at expiration the futures price converges to the cash value of the underlying commodity. The pricing integrity of a futures contract, its efficiency of a price discovery tool and as a risk management tool, depends on the expectation that at expiration its price will reliably represent the legitimate supply and demand factors affecting the underlying commodity.

The overwhelming success of futures markets proves that this is usually the case. In futures markets settled through physical delivery, traders can normally arbitrage between futures and cash to ensure convergence. If the futures price seems too high relative to cash prices, there will be relatively greater interest in making delivery, tending to cause futures prices to fall. If futures prices seem too low, the opposite will occur. In cash-settled futures markets, the final settlement price will necessarily represent the value of the settlement index at expiration.

However, these settlement mechanisms are potentially vulnerable to attempts at price manipulation. In futures markets settled through physical delivery, manipulation or attempted manipulation is likely to involve the use of market power to dominate the delivery process.

For example, a market squeeze would involve a trader holding a dominant long position in excess of the supply available for delivery on the contract.

The long trader could use that dominance to extract artificial prices from traders holding short positions who could not make delivery and would be forced to buy back their positions versus the dominant long trader.

To protect against this type of manipulation, our market surveillance program has two main tools: large trader reporting and spot-month position limits. I will discuss our large trader reporting system in more detail in a few minutes, but the point I would like to make now is that large trader reporting allows us to monitor the size of positions very carefully to detect a possible impending squeeze.

In addition, spot-month position limits mitigate against manipulation by restricting the size of positions as the contract approaches expiration, the period when it is most vulnerable to being squeezed.

Historically, the Commission has used as a guideline that exchanges set spot-month position limits at a level no greater than 25 percent of the normal deliverable supply. The current spot-month position limit for the NYMEX Henry Hub natural gas futures contract is 1,000 contracts.

Manipulation of a cash-settled futures markets occurs more indirectly. Since a cash settled futures market references some other price for its final settlement, a manipulative scheme would involve manipulation of that reference price. In such a scheme, large positions in the cash-settled futures contract would provide the motive for a manipulation, but the manipulative activity would occur in the market for the reference price.

Such a scheme might involve relatively heavy buying in the market used for a price reference to force that price to an artificially high level which would then be used to cash settle a much larger long position in the cash-settled futures market. The formula for detecting this type of manipulative activity is close scrutiny of prices and trading activity in the reference market, along with large trader information about positions that are cash settled using that reference price.

The focus of the Commission's surveillance of energy markets has been on the regulated futures markets at NYMEX. At leats three reasons explain this focus: First, this is the mandate provided by Congress in the Commodity Futures Modernization Act of 2000. Second, the NYMEX Henry Hub final settlement price has played a unique role as a central reference price around which other cash futures, and OTC derivative prices have revolved.

And third, this focus reflects the reality of limited Commission resources.

While each of these reasons still holds, it is becoming increasing apparent that proper surveillance of the regulated markets at NYMEX requires increased regulatory transparency into trading activity of cleared products linked to NYMEX.

With that in mind, I would like to briefly describe some of the key pieces of information that we receive for regulated futures markets, such as NYMEX, and three special calls issued to ICE to obtain similar information.

Pursuant to part 16 of the Commission's regulations, DCMs are required to provide daily data showing aggregate positions and trading cleared by each clearing member, shown separately for house and customer positions. This data includes all positions in futures markets at DCMs but it does not provide information on the size and identity of customer positions.

The centerpiece of the Commission's market surveillance program is its large trader reporting system. Under the large trade reporting system, clearing members, futures commission merchants, and foreign brokers, collectively called reporting firms, file daily reports with the CFTC showing futures and options positions held in accounts they carried that are at or above specific recording levels set by the CFTC. These reporting levels vary by market from as low as 25 contracts for small markets to as high as 3,000 contracts for the largest market, the Euro dollar futures market, traded at the Chicago Mercantile Exchange.

The reporting level for the natural gas future market is 200 contracts. The data provided in these reports in aggregate has covered about 97 percent of total open interest in the NYMEX Henry Hub natural gas contract during the past year.

The Commission also receives large

trader reporting for contracts that are cleared through NYMEX's Clearport facility. Typically, these are transactions initially occurr in the OTC market, through voice brokers and are then submitted to Clearport for clearing. In interviews with industry participants, staff has heard that contracts cleared through Clearport represent a significant portion of the OTC activity conducted through voice brokers.

In addition to large trader reporting for NYMEX markets, the Commission receives from NYMEX daily transaction data. This data provides a complete audit trail of all trades that occur in NYMEX markets. Surveillance staff use this data to closely scrutinize trading activity during key trading periods, especially during the closing range of the final trading day.

The Division of Market Oversight has issued three special calls to the Intercontinental Exchange for information related to ICE's cleared natural gas swap contracts that are cash-settled based on the NYMEX physical delivery natural gas contract -- ICE's look-alike contracts. In each case, the information requested has been analogous to information that the CFTC receives from DCMs, including NYMEX.

The first special call was issued on September 28, 2006, requesting daily clearing member position data, broken out between house and aggregate customer positions. This is similar to information that the Commission receives from DCMs under part 16 of the Commission's regulations. The Commission has been receiving responsive data from ICE since October 10, 2006. With this date, market surveillance staff can see all cleared positions at the clearing member level, but it is not possible to determine individual customer positions from this data.

To address this gap, the Commission issued a second special call on December 1, 2006, to obtain daily individual trader positions. The Commission has been receiving responsive data since February 15, 2007.

While the content of this data is

similar to large trader reporting for DCMs, the methodology for reporting is very different. Large trader reporting for products traded on DCMs is done not by the exchanges but by the carrying firms, generally, the Futures Commission merchants for U.S. traders and foreign brokers for non-U.S. traders. Since the reporting firms know directly these positions, this reporting is fairly straightforward and highly accurate. The Commission's authority to issue special calls with respect to trading and positions on ECMs is limited to the ECM itself. ICE was not, and is not, receiving position reporting from firms. Therefore, in order to comply with the Commission's special call, ICE has developed an algorithm to infer open positions from the sum of all trading by each individual trading firm. While this approach is innovative and has provide very valuable information to the Commission, it is not yet as accurate as traditional large trader reporting.

Commission staff continue to work with

ICE to improve the accuracy of this data. ICE is providing this data in the standard electronic format used for Commission large trader reporting, which has allowed us to relatively easily integrate this data into our computer surveillance systems and to examiner traders' consolidated positions on NYMEX and ICE.

I would like to make a few observations with respect to insights afforded by larger trader reporting for NYMEX and ICE natural gas products. The first point is that the composition of commercial and noncommercial activity in these two markets, as measured by open positions, is actually quite similar.

On a recent day noncommercial traders held about 46 percent of the open long positions and 52 percent of the open short positions in NYMEX's Henry Hub physical delivery futures contract.

On that same date, noncommercials held about 46 percent of the long positions and 36 percent of the open short positions in ICE's linked Henry Hub swap contract. This highlights that there is a substantial overlap of traders in these two markets.

The second observation is based on Commission staff interviews of industry participants in anticipation of today's hearing. When asked how much of the total trading activity involving Henry Hub futures and swaps that the Commission was seeing as a result of large trader reporting of cleared positions on NYMEX, Clearport and ICE, the unanimous response was that we were seeing the vast majority of all such positions.

The most recent special call to ICE was issued on September 5, 2007. This special call requires ICE to provide all cleared transaction data for the Henry Hub swap contracts, identifying counterparties, for the final two trading sessions prior to the expiration of prompt-month Henry Hub natural gas products.

This data is similar to transaction data that the Commission receives from NYMEX for all trading days. When the Commission begins to receive this data, we will be able to monitor trading activity on ICE during these crucial last two days, in conjunction with our analysis of NYMEX trading, to provide more complete coverage to counter possible manipulative schemes.

Thank you, Mr. Chairman, for this opportunity to briefly describe the Commission's surveillance program for energy futures markets.

CHAIRMAN LUKKEN: Thank you, Mr. Fenton. Now, I'm going to open it up for questions to the Commission, and I'll start off the round.

This is a question regarding what you and our chief economist has presented, growing interest in speculative trading. As Jeff's charts pointed out since 19 -- I'm sorry, 2004 to present, we've seen about a 10 percent increase in speculative activity.

John, as you mentioned, it is been on both side of the market, both speculators shorting and long in these markets. How do you approach this? Is this a concern that's growing trend, not just in natural gas but other commodities we regulate? How do you approach this from a surveillance point of view, and is it meaningful from a regulatory point of view in regards to our chief economist's questions? John?

MR. FENTON: Well, the first point, I guess, is the numbers that I cited, and I think Jeff showed as well, is aggregate speculative or noncommercial positions. And so in sum, as long as individual traders are trading properly, I don't think there is great concern about the role of speculation in futures markets.

Obviously, in the energy markets, and in particularly natural gas, a fairly large portion of the noncommercial positions are spread positions. And we know from the experience of Amaranth these are not always risk-neutral positions, but it tends to be a view of relative prices rather than absolute prices.

But as I say, I think that as long as speculative traders are trading properly and are not attempting to manipulate prices, they're part of the mix in the markets and are part of the price discovery process.

CHAIRMAN LUKKEN: Jeff, do you have anything to add?

MR. HARRIS: I think from an economist's standpoint, the thing that I didn't point out in those charts was that the volume itself has grown substantially in these markets. So what we didn't see is there still is a large commercial interest, the major point of, I guess, the initial chart was to show that there is still pretty good healthy mix, and as long as we do have the trader limits that are in place on designated contract markets, then I think it is not a concern from an economist's standpoint.

CHAIRMAN LUKKEN: Thank you. And one quick question for Rick. You mentioned that we have three broad categories in our markets: Designated contract markets, the fully-regulated exchange, derivative transaction execution facilities, DTEFs and then ECMs. And we've seen lots of growth in the DCM category the fully-regulated, and lots of growth in the ECM category. And then we have this big donut in the middle, DTEFs, where no one has taken advantage of this.,

This is something we may want to explore at the next panel, but do you get a feel, intuitive feel of why people haven't registered in this category? Are there certain aspects of the DTEF that are unattractive to these businesses?

MR. SHILTS: In discussions with some people who have inquired about coming in as a DTEF, it seems as though that the major consideration is that which way do they want to go? If you want to become a DTEF, then you do have to set up self- regulatory responsibilities, a compliance program, and meet a number of core principles. They're no as much as a DCM, but that you still have to fundamentally set up a program to oversee your markets. And I think the choice has been if the decision is that if you want to set up a program, then you might, you know, compliance program and meet all these regulatory requirements, you might as well just become a DCM, and then there are no restrictions on the types of products that can be traded or that the types of traders that can participate on the market.

So I think it gets down to the choice that they feel that it is not worth it to kind of go to this middle ground, that if you're really going to -- you're either going to be trade in the kind of the DCM space, but if you do want to become a regulated market, then you might as well go all the way and become a DCM.

That's kind of the general impression, and I think it is a couple of the concerns expressed, and that some of these markets do want to conclude some sort of intermediation, maybe very limited amount of intermediation and that's not permitted on the commercial DTEF market so that again they would decide, well, we'll just -- we'll let go to become a DCM. So it might be that there are certain other aspects of the DTEF requirements that are inhibiting some of these entities from actually using that space.

CHAIRMAN LUKKEN: Thank you. I'll turn to Commissioner Dunn.

COMMISSIONER DUNN: Thank you, Mr. Chairman. And welcome to all of our panelists. I appreciate all the hard work the staff does, and a special welcome to our new general counsel and our new chief economist. Your first times in the hot seat in these new positions, and we'll see how you like it.

Let's just start right off with Terry, and maybe, Rick, you might jump in on this as well. In the development of the Modernization Act, was the Commission asked to comment on the development of the ECMs?

MR. ARBIT: Well, I hate to have that, for my first question as general counsel -- I was actually not involved at that stage.

COMMISSIONER DUNN: (off mike)

MR. ARBIT: I certainly know, as a staff member here, that drafts were provided to the Commission of various provisions, and there was a dialogue back and forth. I'm sorry, I actually do not know the extent of the Commission's input on these provisions in particular.

CHAIRMAN LUKKEN: Rick?

MR. SHILTS: Yeah, I have the same, you know, memory as Terry that there was drafts of various legislative proposals passed back and forth, but I also wasn't intimately involved with that process. I don't really --

COMMISSIONER DUNN: Was it contemplated at the time that they would develop the direction and the size they have for those that are operating now?

MR. SHILTS: That I don't know. I don't know the answer to that.

MR. ARBIT: I would add one thing: At the time that the CFMA was being debated in Congress, the Commission was operating on its own regulatory track, something that was called "the new regulatory framework." And I believe that that had contemplated a three-part regime for exchanges or trading facilities. They had a different terminology, but the equivalent categories were the fully-regulated contract markets and middle category similar to the DTEFs that are provided for under the statute, and a lesser regulated category for, I think what would be sort of equivalent to the exempt boards of trade which we really did not talk about in the testimony, but is also provided in the CFMA.

I don't believe the Commission's new regulatory framework had, in addition to those three categories of exchanges, I don't believe there was another category for this sort of exempt commercial market type of facility.

COMMISSIONER DUNN: Terry, you testified that the -- if there are complaints received by the ECMs, that they are supposed to be forwarded in to the Commission. Are you aware of how many of those we've received to date?

MR. ARBIT: Not -- I don't have the exact number. I don't believe it has been a lot. I don't believe there have been very many.

MR. SHILTS: I think it is been around

five or so. I'm not exactly sure.

COMMISSIONER DUNN: Rick, you have the overall responsibility of surveillance, and is there a difference in, as we're presently going on this ad hoc basis -- and it occurs to me we may be moving back into command and control type of regulations of the ECM to get information -- is there a difference in the cost and the amount of personnel and effort that you put into regulating the two different entities?

MR. SHILTS: Are you referring to the DCMs and these markets?

COMMISSIONER DUNN: Yes.

MR. SHILTS: Well, as Terry had mentioned, we don't do direct oversight of the exempt commercial markets except in the context, as John had mentioned and with respect to the special calls, in getting additional information from ICE in this instance to help oversee NYMEX and the natural gas market.

In general, though, I think there's probably a disproportionate amount of time spent looking at the issues related to exempt markets simply because we don't have an ongoing presence with respect to those markets in the sense that we don't receive rules and product filings on a consistent basis. We don't do rule enforcement reviews or have any other active engagement with those entities, so to the extent that our issues are questions, it is a lot, to a larger extent reinventing the wheel kind of going back trying to figure out what's going on just because we don't have that routine, you know, relationships with the exempt markets.

COMMISSIONER DUNN: Jeff, you had indicated that at any particular time ICE may be leading NYMEX, NYMEX may be leading ICE. Do we have enough data to establish any trends at this point?

MR. HARRIS: Well, the percentages that I reported were actually statistically significant, so in that sense it accommodates for the number of observations during the day. We did exclude the days that there wasn't enough trading on both markets to do the analysis.

COMMISSIONER DUNN: I'm very interested in the economist's interpretation is what is price setting versus what we've seen in legislation. And if you had your druthers, how would you like us to interpret what's price setting?

MR. HARRIS: Well, I think 20 percent, I guess, is the number to focus on perhaps with ICE's appearing to have an impact on prices in this market, in particular natural gas on 20 percent of the days.

It should be noted that some of those days, a portion of those days was where we found evidence that both NYMEX and ICE were leading on those days. So the actual percentage that ICE was leading alone was only in the neighborhood of seven percent of the contract days that we followed.

COMMISSIONER DUNN: John, when you work with the exchanges, you have folks there that are in surveillance and oversight that you call, and if they're approaching a spec limit, they're responsible for calling a stop to that and also on whether or not they're going over their level.

Who do you do that with, with the exempt exchanges?

MR. FENTON: Well, we have contacts, obviously, at -- well, the main exchange that we deal with is -- the main exempt commercial market is ICE.

And there are people there that we know, and we've gotten to know them especially through the special calls. But there is nobody comparable to a compliance or a surveillance person at a designated contract market who I can call to discuss a position in the market or concerns, surveillance concerns, about activity in the market.

COMMISSIONER DUNN: At the time there was alleged manipulation Amaranth, were you and surveillance aware of their position in the exempt market?

MR. FENTON: No, we were not.

MR. ARBIT: Mr. Chairman, just to follow

up on one question from Commissioner Dunn about complaints, some complaints from the exempt commercial markets go to market oversight, some do go directly to our Enforcement Division, so the actual number may -- is higher than the five that was mentioned.

CHAIRMAN LUKKEN: Thank you. Let's turn to Commissioner Sommers.

COMMISSIONER SOMMERS: Actually, I don't have any questions, but I just want to thank all four of you for your hard work, and I appreciate all of the information.

CHAIRMAN LUKKEN: Commissioner Chilton?

COMMISSIONER CHILTON: Thanks. I've just got two quick questions, Mr. Chairman.

Mr. Shilts, you mentioned the possibility of revisiting the criteria for determining price discovery triggers, and since Commissioner Sommers and I weren't here -- and she may know this from her history, but I don't -- why was open interest in volume not included as part of that? Can you explain it to me?

MR. SHILTS: I think to some extent it depends on what the markets have available and make available to post. I think with respect to open interest in particular, I think the issue was that not all of the exempt markets provide a clearing function, and that some of the trades that may be executed on an exempt commercial market, the entity itself may not know the disposition of the trade; they may know the two traders were matched and the trade may be -- was executed. But after that, it is not clear whether they would maintain their positions or they would then do a bilateral swap, and then offset the position. So, in effect, they would have no position, so there would be no open interest in that case.

So I guess, but the real issue there was that you wouldn't know exactly -- the open interest may not be known because there may not be a centralized clearing function. So I think that was the reason for open interest, and I don't recall what the issue was with respect to volume.

I'd have to get back to you on that.

COMMISSIONER CHILTON: Okay, thanks. And this is either for Mr. Shilts or Mr.

Fenton. Say in sort of a dream world that today all of a sudden, boom, 2(h)(3)'s gone. It is gone. Is there some sound, regulatory principle behind allowing the bilaterals to continue to operate with exemptions and exclusions?

MR. SHILTS: Let me just start and John can add. I think there's a couple of reasons, maybe like a principal reason and then maybe a practical reason. I think, generally, the oversight goes to the marketplace, a centralized marketplace where traders go to lay off, hedge their positions. It provides that and the risk management, and that the price discovery positions, is, you know, the key elements of that marketplace.

So I think that to extent, there's a regulatory role: It is to supervise and ensure that those functions are being met, that there's not, you know, manipulation or untoward activity that would include traders' ability to hedge and discovery prices on the markets. And I think when you talk about pure bilateral trading, it is not necessarily focused on a centralized market; it is just two counterparties that execute a trade, so we not have these broader impact on the national economy or warrant some sort of oversight.

And I think the more practical aspect just might be that the bilateral world can be anybody anywhere, and it can be very difficult to actually supervise those people and to identify who they are, and to set up a regime to get information about them because the mature of the contracts could be very diverse and not necessarily standardized. And it just -- it may be very difficult to actually accomplish it, even if you chose to do that.

MR. FENTON: Now I'll follow up on that point. I think it is basically really a cost-benefit issue Potentially the cost of getting information on the bilateral market could be very high compared to our typical reporting regime. And the benefits may be quite low.

We don't need to know every last position that maybe affected by trading in futures markets to do proper surveillance, especially as long as we have authority on a special call basis using our Regulation 1805 to go to traders and ask them, if we have reason to want to know what their positions are in the bilateral market. That regulation gives us authority if the trader is reportable on NYMEX to get that information.

But to have a regime of reporting broadly across the OTC market would, I think, be cumbersome to administer.

One final point: A fair portion of what's happening in the OTC market is being reported to us through clearing either at Clearport or through ICE.

The voice broker market is a major part of the OTC market, and a large and growing portion of that activity is being cleared, and the portion of it that is going through Clearport is being reported to us.

COMMISSIONER CHILTON: So just -- I

don't want to put words in your mouth -- so if 2(h), say, were just gone, then we could continue as a Commission to allow exemptions and exclusions for the bilats?

MR. HARRIS: Yes.

MR. FENTON: I would go along with that, yes.

COMMISSIONER CHILTON: Thanks, Mr. Chairman.

CHAIRMAN LUKKEN: All right, I want to thank the panel for testifying today, and we appreciate it and look forward to assembling the next panel. And we have a couple minutes to put that together -- but don't leave. We'll be right back.

(Recess)

CHAIRMAN LUKKEN: Thank you very much. We have our second panel here consisting of trading facilities in this space.

First we have the Honorable James Newsome, no stranger of the CFTC from the New York Mercantile Exchange. Welcome, Jim.

We second have Jeff Sprecher, Chairman and CEO of the Intercontinental Exchange.

Craig Donahue, Chief Executive Officer and Director of CME Group.

And Peter Krenkel from the NGX.

And via conference in London we have Richard Sandor, who is Chairman and Chief Executive Officer of the Chicago Climate Exchange. Welcome, Richard.

So we begin with Jim Newsome. Thank you so much.

DR. NEWSOME: Thank you, Chairman Lukken, commissioners. I come to this hearing as President and Chief Executive Officer of the New York Mercantile Exchange, and on behalf of the Exchange, I want to express our appreciation to the CFTC for holding this public hearing on exempt commercial markets.

Over the last several months, the role of ECMs have received a lot of attention on Capitol Hill and elsewhere. During this period and prior, NYMEX has observed a broad and growing consensus that certain products traded on ECMs and DCMs are tightly linked and effectively result in one broader market. Consequently, NYMEX along with some legislators and regulators have concluded that there is a need for appropriate statutory change to provide effective regulatory oversight of markets that are critical, of critical importance to the U.S. consumers and to our overall economy.

The debate over the changes in the marketplace I think is now largely settled. The real question becomes the appropriate statutory response.

The CFTC has been an outstanding success, and the tiered statutory structure for trading to sell these has been effective in most respects.

In addition to establishing these tiers, the CFTC also shifted away from one-size-fits-all prescriptive approach to futures exchange regulation to a more flexible approach that included the use of core principles for DCMs and that confirmed the CFTC's role as an oversight agency rather than the prescriptive rules that most issue affirmative approval before any new innovations could be introduced to the marketplace.

As to exempt commercial markets, while transactions executed on an ECM generally are subject to any fraud and any manipulation authority, the ECM itself is essentially exempt from all substandard CFDC regulation and oversight.

In addition, the ECM by statute has no affirmative requirements to engage in any self-regulatory activities to monitor its markets or otherwise to seek to prevent any manner of market abuses.

Since the passage of the CFMA, the series of profound changes have occurred in various OTC markets, including technical advances in trading such that the regulated DCM, or NYMEX. and the unregulated ECM, ICE, have become highly linked trading venues. This result, which could not have been reasonably predicted only a few short years ago, indicates that the current statutory structure no longer works for certain markets now operating as ECMs.

Specifically, the regulatory disparity between the NYMEX and certain ECMs, particularly ICE, which are functionally equivalent to each other, has created serious challenges for the CFTC and for NYMEX in its capacity as a self-regulatory organization. It has become apparent to NYMEX that the structural issues raised by changes in the marketplace cannot be addressed effectively at the level of the individual exchanges.

For example, earlier this year in an effort to cooperate with the Federal Energy Regulatory Commission and following consultation with the CFTC staff, NYMEX issued a compliance advisory in the form of a policy statement related to exemptions from positional limits in NYMEX natural gas futures contracts. NYMEX adopted this new policy on an interim basis and a good faith effort to carry out its self-regulatory responsibilities and to address on an individual exchange level the market reality demonstrated by Amaranth's trading on both regulated and unregulated markets.

However, the new interim policy implemented by NYMEX has, 1) reduced volume on NYMEX during the critical 30-minute closing range period; 2) presumably shifted volume from the regulated to the unregulated trading venue; and 3) has failed to solve the structural imbalances brought to light by Amaranth trading.

In addition, this policy would create new problems by diminishing the vitality of the natural gas industry's pricing benchmark. Consequently, NYMEX now believes strongly that legislative change is both necessary and appropriate. NYMEX believes that a targeted approach that directly addresses the specific issues raised by these industry challenges would be the most effective policy response and would provide the greatest assurance of limiting the unattended consequences of more sweeping and draconian changes.

In particular, for those products traded on ECMs that have triggered public policy interests and concerns, NYMEX believes that the CEA should be amended to require a routine mandated large trader reporting and position accountability requirements for financially settled ECM contracts that are highly linked and functionally equivalent with regulated DCM contracts. Such ECMs also must be assigned self-regulatory organization duties to police their own markets and to submit applicable rule changes to the CFTC in a manner similar to other regulated entities.

NYMEX believes that such statutory changes are necessary and appropriate and would not negatively impact the core price discovery and hedging functions provided by derivatives markets. NYMEX does not believe that the case has been made for extending such heightened regulation to other products listed on an ECM to other ECMs that have not triggered these policy interests and concerns or to the traditional bilateral OTC market.

On the other hand, the targeted approach that NYMEX recommends should not unduly affect the ability of ECMs to be sources of innovation, including the adoption of new trading technologies.

Mr. Chairman, I thank you for the opportunity to appear before the Commission today and certainly will be happy to answer any questions at the appropriate time.

CHAIRMAN LUKKEN: Thank you, Mr. Newsome.

Mr. Sprecher? Please pull the mikes, if you can, about six inches from you. That helps with our audio.

MR. SPRECHER: Acting Chairman Lukken, Commissioners Dunn, Sommers, and Chilton, and staff members, my name is Jeff Sprecher, and I'm the Chairman and Chief Executive Officer of Intercontinental Exchange which you know as ICE. I very much appreciate the opportunity to appear before you today to discuss the operations of ICE and to share with you our views on the regulation of exchanges and of exempt commercial markets.

Today ICE operates a leading global commodities marketplace which comprises both futures and over-the-counter contract markets across a variety of product classes which include energy, agricultural products, foreign exchange, and equity indices. ICE provides these important risk management contracts to commercial hedgers as well as to speculators who provide necessary liquidity in our markets, and we do that through an integrated electronic trading platform.

We currently host three separate markets on our electronic trading platform. ICE's OTC energy market which operates under the Commodity Exchange Act as an exempt commercial market and two regulated futures exchanges: ICE futures U.S., which was formerly known as the Board of Trade of the City of New York, and ICE futures Europe, which was formerly known as the International Petroleum Exchange.

We will soon be adding a third

regulated futures exchange to our platform with the recent acquisition of the Winnipeg Commodity Exchange. So it is fair to say that we at ICE uniquely understand both the value and the limitations of regulated trading as we operate three global futures exchange franchises. ICE began its existence in year 2000 as an over-the-counter execution market, and since that time we've grown significantly both through organic growth fostered by innovation as well as by acquisition.

When focusing solely on the breadth of ICE's business, it is tempting for a casual observer to apply superficial analysis of the appropriate level of regulation for very highly -- for highly varied markets. After all, one could ask if ICE offered its regulated futures contracts through part of its business, why shouldn't it offer the same level of regulation for all of its businesses, including over-the-counter markets?

Such a superficial top-down analysis is fraud in my opinion, as it does not consider the highly varied nature of traded over-the-counter markets. and, importantly, how these markets fundamentally differ from futures markets.

As I recently testified before Congress, a heightened level of DCM-like regulation, including reporting and position accountability may be appropriate for certain of ICE's cleared OTC swap contracts that settle on futures markets and that are the economic equivalent of actively-traded futures contracts like our Henry Hub natural gas swap.

However, applying a standard DCM level of regulation more broadly to all of the various swap contracts that are traded on ICE either through the application of DCM-like core principles or worse, by eliminating the category of exempt commercial markets altogether, would be a serious mistake that I believe would not only result in less market efficiency but ultimately would bring harm to the constituency that the Commission is charged with protecting. And that is the end users of the markets.

In considering this question, it will be important to distinguish between actively traded contracts that serve as pricing benchmarks on designated contract markets and those that start life as oft-exchanged transactions that are merely cleared through a clearing house.

Finally, without the proper historical context, it is easy to lose sight of the reasons on how ICE was able to be formed, on how ICE fits into the broader context of the over-the-counter markets and the benefit that ICE has brought to the broader marketplace.

In the framework of this hearing, I hope to illustrate that a one-size-fits-all level of regulation is ultimately misguided. The marketplace has benefitted significantly from the regulatory flexibility that's embodied in the CFMA and through the ECM category of markets that's recognized by Section 2(h)(3) of that Act. In this regard, proper recognition should be given to the Commission and to those that supported the CFMA, including Dr. Newsome for the real and tangible benefits that the CFMA has brought to the marketplace as a result of its adoption.

I thank you.

CHAIRMAN LUKKEN: Thank you, Mr. Sprecher.

Mr. Donahue?

MR. DONOHUE: Thank you very much for inviting me to be with you today.

I'd like to begin by complimenting you on your able administration of the Commodity Exchange Act and on your willingness to ask difficult questions as to whether the CEA can be improved based on experience and evolving market needs. The CEA ha been tremendously successful, no doubt, and the CFTC has administered it extremely well to the great benefit of customers and the national economic health.

That said, the record indicates that there are important issues arising in the context of ECMs that need to be addressed. CME Group supports CFTC's review of those issues and urges responsive action in that regard.

Historically, there have been distinctions between OTC trading platforms and regulated exchange markets. I believe those distinctions have now blurred to the extent that disparity of regulatory treatment is no longer justified. OTC trading platforms and regulated exchanges are rapidly converging in every material respect except regulation.

Customers for financial futures and nonagricultural futures, so-called exempt commodities, on regulated exchanges, or so-called DCMs, are increasingly also customers of OTC electronic trading platforms. Product innovation or extension coupled with enhanced trading functionalities have dissipated the distinctions between exchange and OTC markets.

OTC platforms today list standardized contracts that can be executed by the push of a take button, and, similarly, regulated exchanges like CME Group are offering standardized swaps and other contracts that trade in OTC type market structures or execution mechanisms.

Similarly, credit barriers that once prevented certain customer segments from accessing OTC markets have broken down with the growth and prime brokered services providing credit enhancement and access to multilateral trading opportunities in much the same way as central counterparty clearing systems do.

Indeed, as this convergence continues, I strongly believe that some form of central counterparty clearing is inevitable in the OTC market. These areas of convergence in our markets create a growing conflict between the goals of the CFTC and the exemption for ECMs found in Section 2(h)(3).

In light of the controversy generated by the NYMEX/ICE situation, I believe this is a very appropriate time to reexamine the Commodity Exchange Act's exemptions and exclusions and to consider whether any recalibration is necessary in order to protect users of these markets.

Specifically the elimination of the exemption for unregulated commercial markets must be seriously considered.

I believe that the President's working group position on this topic during the Commodities Future Modernization Act process was correct and had its correct focus on the concern about the potential manipulation of these kinds of products in an unregulated environment and not whether these products would ultimately trade in some fashion linked to a regulated exchange market.

As a result of its investments in both the regulated and the OTC markets, CME is uniquely positioned to comment on this topic. We operate a very successful DCM for financial derivatives. We are also expanding into the exempt board of trade markets with OTC offerings on FX markets base and swap stream as well as clearing 360, and I should note as well that we've been very successful in developing over the counter products like weather in the construct of a DCM.

While the primary subject of today's hearing involves an area where the CEA needs amendment to address shortcomings, it is important to put that area of controversy in its proper perspective. The problems associated with ECMs are not representative of what is the overwhelming success story that is the current CEA as amended by the CFMA. We enthusiastically applaud Congress and its oversight committees in having the wisdom and courage back in 2000 to enact a modern, progressive principles-based regulatory regime for the CFTC. We believe the marked success of the U.S. futures industry under this regime has created a compelling example for the securities industry in the United States.

In our view, reducing barriers to entry in global futures and options has strongly contributed to business growth and increased competition. As an example, the compounded annual growth rate in the global futures and options industry over the last five years was 28 percent compared to only 4 percent for equity securities markets.

This is due, at least in part, to the

fact that U.S. investors can directly and electronically access foreign futures and options contracts from the United States. Correspondingly, European and Asian investors can directly and electronically trade products listed by CME and other U.S. futures and options exchanges. Moreover, foreign boards of trade can effectively offer U.S. Customers access to products also traded on U.S. Exchanges, thereby increasing global competition in these markets.

In contrast, under SEC rules, U.S. investors cannot directly and electronically trade foreign equity securities of foreign issuers that do not comply with SEC disclosure standards or U.S. GAP accounting standards.

The CFTC and Congress have wisely promoted global growth and competition while recognizing that comparability and regulatory standards is superior to insisting upon additional but not necessarily better regulatory requirements.

I look forward to answering your

questions. Thank you.

CHAIRMAN LUKKEN: Thank you, Craig. Mr. Krenkel.

MR. KRENKEL: My name is Peter Krenkel. I am the President of Natural Gas Exchange, also known as NGX. I want to thank the Commission for providing me with an opportunity to participate in this hearing today.

Although the majority of NGX's operations are currently in Canada, from our perspective, the natural gas market is now continental in nature and the border effectively no longer exists. The U.S. currently purchases about half of Canada's natural gas production and is a significant purchaser of crude oil and other energy sources.

The U.S. regulatory framework has an impact not only on NGX as an exempt commercial market but more generally in terms of the direction in which Canadian regulation evolves.

NGX is a Canadian company based in Calgary and is a wholly-owned subsidiary of the

TSX Group which owns and operates senior and public venture equity exchanges in Canada, known as the Toronto Stock Exchange and the TSX Venture Exchange. TSX Group purchased NGX in 2004 and recently acquired an option to purchase NetThruPut, Inc., a Canadian-based oil exchange exercisable in March of 2009. As publicly disclosed, NGX entered into an alliance with the Intercontinental Exchange in March of this year which primarily involves the provision of certain services by ICE and certain clearing services by NGX.

NGX launched this business in 1994 with an electronic system and has never operated a floor. NGX provides trading, clearing and settlement services for natural gas and electricity instruments in key markets, primarily in Canada. At present, the bulk of our business is physical natural gas contracts with the greatest liquidity at Alberta and on Ontario markets. Our electricity business has evolved over the past five years and is starting to develop some liquidity levels.

NGX participants based in Canada and the U.S., all of which are sophisticated entities and transact as principals, the majority are energy companies and, in recent years, we've seen the participation by more banks and hedge funds, some of the non-traditional players.

Participants' bids and offers are entered into the electronic trading system, matched on a price-time priority basis. NGX is the central counter party in every transaction and, as such, ensures that each transaction is firm and anonymous from trading through clearing and settlement.

Since launch, our traded and cleared volumes have grown gradually to current levels of over 900 BCF a month or approximately twice the Canadian underlying physical production. Over 95 percent of our volumes are spot and forward physically settled contracts.

Our business plan continues to be to develop new OTC-style products that are traded and cleared in accordance with our standard terms and conditions. We have developed certain unique products such as balancing instruments that enable participants to correct imbalances in their pipeline accounts which have provided considerable benefit to the marketplace and the pipelines.

NGX has brought many benefits to participants in the energy markets such as increased transparency, standardized rules, the financial discipline associated with margining and clearing, and providing an alternative for dealing in bilateral credit issues. NGX provides the unique service of clearing physical contracts which includes managing daily deliveries of gas. In addition, our platform is widely used to determine several key price indices that are widely used in contract settlements by the OTC markets and other exempt and regulated exchanges.

In Canada, regulation of commodities trading is a provincial matter. NGX has exemptive relief as a commodity exchange from its primary regulator, the Alberta Securities Commission. The exemptive relief order is based on certain terms and conditions being satisfied including compliance with nine operating principles that embody principles-based rules. NGX is essentially audited by the ASC on a regular basis which is comprised of an annual oversight review that tests our compliance with the operating principles.

We also have exemptive relief orders from the applicable provincial regulators in the other Canadian jurisdiction. We've been an ECM under U.S. law since 2002.

As the energy markets in Canada are inextricably linked with those in the U.S., NGX's business perspective has been global. In our view, it is essential that there be a comparable regulatory regime on both sides of the border. The ECM structure is, in general, more consistent with the type and degree of oversight currently provided by the Canadian regulators, hence, reducing our burden of double regulation. We believe the regulatory regime must be flexible enough to accommodate diverse business models and to maintain the appropriate balance between regulatory oversight and ongoing evolution of the robust and transparent energy markets.

NGX supports principles-based regulation and having different levels of regulation that take into account the important distinctions between trade execution facilities such as the degree of sophistication in the market, the types of instruments being traded and the liquidity of the products. From our perspective, the ECM regulatory framework has been successful in striking this balance.

In closing, NGX is a proponent of effective and efficient regulation and has embraced regulatory oversight on both sides of the border. We continue to be dedicated to the goal of ensuring greater transparency and maintaining the integrity of the markets which, in part, relates to the ongoing sharing of information with our regulators including the Commission. We embrace opportunities from both an external and internal perspective for regular reassessment of oversight and look forward to participating in the dialogue today on this subject and going forward.

In closing, thank you, Mr. Chairman, for the opportunity to appear before this Commission.

CHAIRMAN LUKKEN: Thank you, Mr. Krenkel. Now, if the audience would turn to our video screens, we have Dr. Sandor from London of the Chicago Climate Exchange, also an ECM in this space.

Welcome, Richard. We have you on video, so please proceed with your testimony.

DR. SANDOR: Thank you very much, Mr. Chairman. It is a pleasure to be here in London but be able to talk with you directly about our exempt commercial market.

We are the Chicago Climate Exchange, and for those of you who are not familiar with the exchange, it trades in the right to emit and that is known as cap and trade where pollution rights or rights to emit or allowances are given out to a variety of industries at lower levels of emissions that prevailed previously.

If an individual firm can reduce its emissions, it is free to sell those to others who may have a technology breakthrough. It may take years to build something. So it provides affordably the solution to problems associated with climate change and emissions.

Indeed, the most successful program ever launched anywhere in the world is the acid rain program of the Clean Air Act of 1990. Being an ECM in the Garden State has been a very exciting opportunity for us. We were able to not only create an exchange but invent an entire new commodity in that we are private Kyoto Protocol. As opposed to enforcement by the federal government, we require contract law. We now represent 12 percent of the United States large stationary source of emissions and our market approximates Germany in its size and breadth.

The members include for of the Dow 30 companies, technologies, IBM, Intel DuPont, the biggest utility in America, ADP and acid waste management, the biggest companies in the country, International Paper, thousands of farmers including the Lugar Stock Farm, Mr. Chairman, in your state, as well as farmers throughout Iowa and Kansas, Nebraska, et cetera.

Our business model and speed to market has helped keep the United States competitive, we believe, in the growing trend toward recognizing the net effects of climate change. Being an ECM in a new product, we were very concerned because the product was new, that we purchased regulatory services and went to the NASD and under a commercial contract they provide market surveillance and monitoring.

We are indeed very concerned about the space of trades that go on, most recently here in Europe, money laundering for emissions trading, climate change. We felt that we had to be like Caesar's wife, simply beyond reproach.

We thought the upside of NASD helping us not only monitor and surveil but also clarifying the fact that the industrial engines made be emissions that they claim to. This was a very,

very critical role. The credibility that the U.S. would in fact, in a privately administered system, have the same monitoring and clarification protocols independently attested to by an SRO was very important for our national efforts.

As an aside, we do also in the United States operate a futures market that is regulated by the CFTC. We trade SO2 allowances -- that is acid rain -- and dominate that market, both futures and options. Other criteria for products such a futures market on our unregulated commodity, carbon, as well a market on certified emissions reductions that are approved by the United Nations, the first such market in the world, and we also operate a stock index of renewable energy futures.

Our experience on the regulated side of the surveillance and oversight by the CFTC has been fantastic, and our ability to operate in the ECM market without undue costs and speed to market helped us form a new exchange, beginning an innovation that we think will have profound effects for the world. We do believe strongly that pollution is very, very critical and that market-based incentives are even more important in dealing with this important social issue.

Thank you.

CHAIRMAN LUKKEN: Thank you very much, Richard. We will start our five-minute rounds of questions. I will begin. It seems to me from hearing from all of the panelists that the tradeoff and really the question for policymakers is one of regulation versus innovation and where you strike the right balance. We have some good examples with one of the founding fathers of financial futures, Richard Sandor here, talking about how this space has allowed for innovation for carbon credits and other areas, and certainly ICE is a good example of somebody who has grown up in this space and has become a competitor and brought competition and lowered costs in this area.

So how do we strike the balance? There are some suggestions of getting rid of this entire exemption altogether. What are the tradeups that we should be considering?

Certainly, there seems to have been a rejection, a moving away of a one size fits all structure in the CFMA in 2000. Are we reverting back to that by suggesting everybody should go into one regulatory category or is there a way to create a tiered system that is indeed tailored to the risks?

I'm not suggesting that we don't try to meet the risks to public here but try to at least calibrate the system so that it fits the risks involved in a lot of this trading but still allow incubation, innovation, competition to develop in these markets.

So this is sort of a broad statement and question to the panelists. If anybody wants to jump in, I'd certainly be interested in your thoughts.

DR. NEWSOME: Mr. Chairman, I might start if that's okay. I would simply say that there's probably no one who has more pride of ownership of the CFMA, having implemented that regulation when I was chair of this great agency, and I believe it has worked. I think it is worked very, very well. I think the tiered structure has worked well.

It has provided for innovations and advancements in technology that have created competitive scenarios for traditional exchanges such as NYMEX. It is forced us to change to become more competitive, and I think the industry as a whole has benefited from that. So, certainly, I think those are the positives.

I think the one negative is that, as good as the CFMA was, I think it is impossible to predict how all markets will develop, and I think that's certainly the case with natural gas. NYMEX is not making broad statements with regard to other contract areas because of the hundreds and hundreds of OTC markets that currently exist, to our knowledge, nat gas is the one who kind of fits the criteria that we've been talking about, and our solution has been just to focus in that marketplace to provide the Commission with some thoughts in terms of how you can capture a market that ends up developing like the natural gas market has developed.

If others, over time, meet those criteria, then we believe that the CFTC should have the flexibility then to pull them in if they become linked to an exchange market, if they serve as an effective substitute for an exchange contract and if they, in turn, aggregate the risk which is not typically the case with a traditional bilateral OTC.

CHAIRMAN LUKKEN: Thank you. Anybody else?

MR. DONOHUE: I'd like to respond to that. I think, first of all, I think the CFMA is certainly flexible enough even without the ECM category which, as I indicated earlier, we think should be repealed.

Secondly, I think as importantly though, innovation certainly can occur in the context of a DTEF or in the context of a DCM, and I think the case has not made that eliminating the ECM category will impair innovation in some fashion especially relative to what we've noted are the substantial risks of manipulation in these markets.

CHAIRMAN LUKKEN: Anybody else?

MR. SPRECHER: Mr. Chairman, I think one of the things that I took away from the first panel and then taking away from a broader debate on Capitol Hill about this is that the issues that have arisen particularly around ICE have to do with the Henry Hub natural gas swap. In an effort to improve the market, which you staff has been doing and which we've been working with them on, somehow the debate has gotten incredibly broad to the point that we're talking about natural gas in Canada and carbon credit derivatives and SO2 emissions.

We have a thousand products that trade on our platform. Exotic derivatives, niche products that I don't believe a futures style of regulation would even help and, in fact, as I said in my prepared statement, I actually think we could inadvertently hurt consumers by putting a seal on approval on those contracts as if they are sources of price discovery, as if they've had oversight, as if we collectively agree that the people should rely on them, because I don't think they should.

So I hope that, in the context of this debate, we can separate the problems that I think there are a lot of people that see and then a broader implication for other markets which, unfortunately, I've seen some testimony sort of drift to, in my opinion, become overly broad.

CHAIRMAN LUKKEN: Thank you.

DR. SANDOR: It is Richard Sandor. I wondered if I could just make one or two comments.

I am shamelessly self-interested in innovation. Whatever small success I may have had, it is been in inventing new products. We are looking at things like endangered species, and I just feel that trying to develop that under a highly regulated structure doesn't serve the public interest. Inventive activity has driven this business.

Virtually, all of my fellow panelists, certainly in the organized exchange area, Jim and Craig and Jeff, none of our products existed when the CFTC was formed. I mean 100 percent, virtually, of what is traded, save the currencies, didn't exist for most of our financial products.

I would urge you to really consider do you have to get rid of an ECM because one is worried about saving polar bears and having a bold market structure. The legal costs associated with this will, in fact, I think limit creativity, and I do believe that much of the emphasis today is on expanding capital markets in the United States and abroad, allowing American firms to compete internationally. One of the vehicles, ECMs, do allow us to invent very odd and exotic products. They have very little to do with the public. Putting a regulatory structure on that, it just doesn't seem that that is the best social solution.

MR. KRENKEL: Mr. Chairman, from NGX's perspective, we have a couple of points that I wanted to make.

We currently list about 160 different instruments. Only about 10 of them are successful in terms of generating adequate levels of liquidity. It is very competitive. We fight daily with the OTC market to bring liquidity from that unregulated space onto our exchange and our facility.

Innovation is the key. We tend to roll out, on average, one to two new instruments a month. We develop these based on consultation with the markets. We need to move them fairly quickly. When they are successful, there's a lot of benefit to the market. When they're not successful, we simply delist them. So whatever regulatory changes are contemplated, hopefully, it will not impair our ability to do that.

The other issue is on the cost side, of course, fees. We compete for liquidities. Fees are a big driver of that. We don't want to see our overhead increase to where we have to try to pass that fee on to the customer, hence, perhaps driving that liquidity back into the unregulated OTC market.

The last point is simply on -- I mentioned it in my opening remarks -- coordination of similar levels of regulation with the Canadian regulators. Our concern is that we end up imposing two sets of rules for our customers based in Canada and the U.S., creating potentially further segregation of that scarce liquidity on the markets.

CHAIRMAN LUKKEN: Thank you very much. Commissioner Dunn.

COMMISSIONER DUNN: Thank you very much. I guess I heard former Chairman Newsome say it was all working well when he was here.

(Laughter.)

COMMISSIONER DUNN: Richard Sandor, let me tell you about the interest in what you're doing in the climate exchange. I am fortunate enough to chair the agricultural advisory committee, and it is been a long time since I've heard this much chatter about good things happening on an exchange that I've heard from what you're doing there. So the farmers and ranchers are really enthusiastic and excited about it.

I'm going to ask kind of a long question and ask all of you to respond to it. The question really revolves around what is taking place in Congress because what we're seeing is Congress looking at a problem and coming out with a bullet solution rather than a shotgun solution, and they're zeroing in on energy right now, but there are other exempted commodities out there, metals and chemicals, that may develop into the same type of problems that people perceive in the energy area.

In your perspective, should Congress come out with a narrow fix or do they need to look at a broader fix, looking at all the exempted commodities and come up with some type of a sliding scale that will say here's where you ought to begin thinking about core principles and when you shouldn't?

The other part of that question is why aren't DTEFs working? Is it just too simple to say I'd rather be an exempted rather than be a DTEF?

If I can just start over here and let you all take a shot at that.

DR. NEWSOME: Thank you, Commissioner. I think a couple of things. One, I have tremendous faith in this Agency and in the quality of both the staff and the commissioners, and the faith that I have somewhat paints my view of how the Congress should move forward. In my opinion, the Congress should move forward with general criteria that we've discussed most recently that would capture the natural gas market as it currently exists because that is the one market that we think is at issue. If other markets develop similarly, then we believe the CFTC should have the flexibility then to capture those markets and pull them in.

NYMEX believes it would be a mistake for

Congress at this point to go ahead and capture all of those markets and pull them into a regulated status. So we think the CFTC should continue to have flexibility to identify and pull those markets in to a higher level of regulation.

With regard to the DTEF, I would agree with the CFTC staff comments earlier. The DTEF is viewed kind of as partly being pregnant and nobody wants to be there. They either don't want to be regulated or they're willing to be fully regulated. The differences between the DTEF and the DCM are not that great. So if someone is willing to go forward with the SRO responsibilities, I think for the most part the assumption is let's go for the full deal and become a DCM.

Before I finish, I wanted to go back to the question you asked of senior staff earlier about the Commission's opinion on exempt markets, and I happen to be here at the time, was involved in a number of those discussions, and I would answer it two-fold. One with regard to financial markets, the Commission was very involved in that discussion, provided the due diligence to the President's working group that gave the PWG the comfort to determine that financial markets should, in fact, be exempt.

Energy and others were very late to the equation. I think Mr. Rasler, on behalf of his clients, did a great job of raising other potentially exemptive markets late in the process. The Commission did not take a position on energy or others at the time simply because we had not done the due diligence that we had done that gave us the satisfaction with regard to the recommendations on the financial markets.

COMMISSIONER DUNN: Thank you.

MR. SPRECHER: First of all, I agree with Dr. Newsome that I'd like to see.

First of all, I believe you have the authority to regulate ICE and to get data from ICE and to improve the Henry Hub market. In fact, if I didn't believe that, we'd be fighting you and we're not. We spent hundreds, maybe now thousands, of man hours with some of the best technology people in the world that work at my company to try to figure out how to take an OTC-cleared swap that is cleared in London and convert that to a futures equivalent that can go into a reporting system that, I'll generously say, has a slightly older technology and to make it so that staff can have the view that I think we all want them to have.

And so, I believe you have that authority. If Congress wants to codify that, send a message, that would be fine. In fact, we've participated in some dialogue as has Dr. Newsome in potentially doing that, but the reality is I don't think it needs to be done. I think you have the authority.

More broadly, I would love to see if we had a magic wand and could wave it over Congress, I would love to see them give you a principles-based regulatory regime. There is no reason in reality that an energy swap is different than an interest rate swap. Energy swaps are becoming so complicated today. There are literally interest rate swaps that pay in interest based on a settlement price of an energy contract. I mean they have morphed into the same thing in certain regards. So if you had a more principles-based approach, I think when you saw a problem, you'd have the flexibility to go after a problem.

One of the issues with this debate has been we're focusing 2(h)(3) and DTEFs and DCMs and so on and so forth, and we're trying to fit things into boxes, and it is very complicated to do that. I would love to see a broader approach. I don't have high hopes for it.

I will tell you, as a manager that runs a business in London where they have a principles-based approach, I think it works pretty well. It is also quite intrusive, I will tell you. It is not a hands-off regulatory style. But, net, the kinds of issues that we've been having in our energy markets here that have dominated the news tend to be resolved better in my mind in the European solution, so I'd love to see you have that hand.

Oh, on the DTEF issue, Dr. Newsome has it exactly right. To the extent we were to become a DTEF, you basically become a futures exchange. DTEF prohibits certain classes of users. Once you've made that investment, why not let everybody trade in markets is the thinking.

In saying that, I will tell you I'm also arguing to you that I don't think we should allow retail customers and non-sophisticated players in many of the markets that ICE trades which is why we have not made them futures. We've sort of self-selected that some of these are inappropriate for people. In a way, you all have depended on a management team to make that decision, and so far I think we stand by our decisions.

But if we were to become a futures exchange, I know our volumes would go up. I suspect that we would make more money, but I'm not sure in the long term, it is the best thing for the markets which ultimately would affect my company, if that makes sense.

MR. DONOHUE: Well, I'm going to start with the caveat that I don't know a lot about the polar bear market, but I do think that the fundamental question is --

MR. SPRECHER: I thought you guys had every market.

MR. DONOHUE: We're working on it. The fundamental question really is the potential for manipulation in these exempt commodities and, Commissioner Dunn, I definitely think that the line should not be drawn simply at energy. There is certainly the potential for manipulation in various of the other exempt commodities, and I think that is fundamentally the question.

I think the points about DTEFs and DCMs and some of the differences and being half pregnant or not are really the wrong area of focus. I think the real question is should there be some effective system of self- regulation involving an effective system of surveillance and compliance programs for exempt commodity markets, and I think the evidence is quite clear that I think that is quite necessary at this point.

I would differ somewhat with Mr. Sprecher in that I think access to information, information gathering alone or information reporting is just not a good substitute for an effective and comprehensive system of compliance and surveillance. I think that if that were in place, I don't think we would have seen the problems that we did in the Amaranth situation, and I think you can easily see that being extensible into trading of these various other exempt commodities.

MR. KRENKEL: Mr. Chairman, first of all, on the DTEF matter, I agree with what's been said before. It didn't seem like a logical place to stop. You would either go all the way or stay in the ECM space.

From the perspective that you've singled out natural gas, it certainly has captured a lot of the headline space. I would agree that it is really a reflection that some of the things that have happened there have resulted in a very successful market.

Trying to provide some uniform regulation across that entire commodity will be very challenging because we see buyers and sellers in the very simplest form trading day gas, trading imbalances, trading yesterday's gas out to the very sophisticated instruments that are available either on the exchanges or in the LTC markets off exchange. So trying to single out natural gas as a commodity that requires more regulation will have some significant challenges.

DR. SANDOR: As Richard said, Commissioner Dunn, thank you very much. I think it is just only the beginner for America's farmers and ranchers, and I hope we can continue to provide an alternative source of income.

I would like to simply say and I'm only speaking from the point of view of the Chicago Climate Exchange, I don't believe that we have any less of a standard with regard to manipulation. We have hired the LASD that does provide regulatory services.

If you were to say you away with the ECMs of any sort, you would do away with a fully regulated exempt market in that it has cobbled together through farm bureaus, as aggregators, through SROs created in 1938 by the Maloney Act like, which is a former NASD. They provide monitoring. They provide surveillance. They provide anti-fraud. They provide no manipulation.

It just seems to me as a student of inventive activity, why would one simply throw out a structure like that, that has five years of operation, a history, has never been called the desk, is fully surveilled and monitored and to say that that is not an organization? To do that is to speak against the new and the innovative and to try to limit creativity.

I can only tell you from our point of view, we have had no problems whatsoever in either measuring forward space, ensuring it complies, making sure that there are no big utilities manipulating the market, and it works, and that's the only ting I can share with you.

DR. NEWSOME: Just once further comment, Commissioner, and thank you, Mr. Chairman. There has been a lot of discussion about manipulation, and certainly that's a logical discussion to have. But if you go back to Amaranth and you look at NYMEX from an SRO standpoint, certainly manipulation was a concern but just as big a concern was systemic financial risk. When you have the aggregation of those OTC positions and through that aggregation you get aggregated risk, that was our biggest concern at the beginning of not allowing that risk to become systemic. I think that potentially systemic financial risk has to be a component of the conversation just like manipulation.

COMMISSIONER DUNN: You were like our staff. You were unaware of the total position.

DR. NEWSOME: Yes, we obviously knew the NYMEX position but had no way of knowing others.

MR. DONOHUE: I have two comments I'd like to add to what Dr. Sandor said. What I heard him say is that effectively he has the kind of regulatory programs and surveillance and compliance capabilities of a regulated exchange, perhaps a DCM or a DTEF. If that's the case, then I wonder how onerous those requirements would, in fact, be for him given what he's created through his outsourcing arrangement with NASD or perhaps there are differences and perhaps those differences are material.

I don't know the answer to that, but I think that's an important question to ask.

Secondly, on the topic of innovation --

DR. SANDOR: I'll be glad to give you the answer to that, and it is a very simple thing, but someday I hope we're going to be as big and strong as all of the members up in the panel.

We're a new entity. We have limited financial resources, and it is a barrier to entry to go through the time and all of those things. I spent seven years researching this particular product full-time and 15 years part-time. I have five full-time accountants, and I spent more on lawyers in the first year of operation than I did in the 15 years of inventing the product.

Speed to market is very, very important particularly for a new entity because we are resource- constrained. It does take these times. Having the exempt market made us good. Putting it away and cobbling it so that we got in principle what we needed and could be inventive. Including farm bureaus and NASD and others, we were able to put together a lower cost regulatory system from certain points of view.

And so, it would place the new inventor at a competitive disadvantage, and I don't think we want to do that. Particularly if you're dealing with a new commodity that's small, why would we want to make one suit fits all?

Take a commodity of seven polar bears, to use your example. You're going to corner the polar bear market, and you're going to worry about the public's view of the polar bears. While you're worrying about it and studying it, the polar bears die. So I think you ought to look at creative structures.

MR. DONOHUE: The second point I wanted to make is again on the point of innovation and thinking about how successful we have been in heating and cooling degree day, weather futures contracts, if you will, in the context of a designated contract market regulatory environment versus the success that I know Richard has had at the Climate Exchange in emissions. So I think it is a clear example of how I don't think the DCM structure of the DTEF structure is in any way a barrier to creative products.

Essentially, there isn't really a very large OTC market at this point in weather because it has migrated to the environment that we provide.

MR. SPRECHER: Could I make one comment? That's easy to say when you start with the largest future exchange, but I started what my checkbook.

MR. DONOHUE: We started with zero volume in weather.

MR. SPRECHER: I can tell you that to

build a futures exchange as a single individual with a checkbook, which is how I started, would have been a daunting task.

CHAIRMAN LUKKEN: Okay, thank you. Let's move to Commissioner Sommers.

COMMISSIONER SOMMERS: Thank you. I have a couple of different questions, the first one for Dr. Newsome.

You talk a lot about the targeted approach and the advantages you see to that. Can you go a step further and talk about where you see the disadvantages to the deletion of 2(h)(3)?

DR. NEWSOME: I think many of those disadvantages have been discussed today. That marketplace has been a real innovator both in terms of technology. I think it serves very nice niche marketplaces that a fully regulated futures contract probably would not be able to serve as well. So I think there are a number of reasons why 2H3s are important.

As we said, our targeted approach would represent some flexible criteria for the CFTC to evaluate and make determinations on a case by case basis. We think that would be a good approach to solely address what is and what may become the problem areas.

COMMISSIONER SOMMERS: Thank you. One more question in a different vein for Mr. Donahue.

You talk about the DTEF category and how you think that could have advantages over where we are with ECMs. Do you see that that could have any kind of global implications?

MR. DONOHUE: I'm sorry, Jill.

COMMISSIONER SOMMERS: That's okay.

MR. DONOHUE: Yes, I think there's a global implication to everything that we're talking about, and we can become myopically focused on if we don't choose to do the right thing, what will be the implications of that. If we eliminate the ECM category, will all of the business flow offshore to less regulated environments?

But I really think that we have a very flexible structure, perhaps too flexible. Maybe we have too many tiers, and the allowance of trading in these kinds of exempt commodities certainly are subject to manipulation. If the exempt commodity list had been broadened to include real agricultural commodities, I doubt for a minute we'd be worried about whether we should be imposing some level of regulation and oversight and requirements for effective surveillance and compliance in those areas.

I find it troubling that we're willing to talk about that in the context of markets that have become very large including energy derivatives and metals and other categories of exempt commodities. So I think it is a question to ask in the big scheme of things, but it should not be the determining factor.

I think I'll go back to what I said before. I mean CFMA has been a remarkable success. The U.S. futures industry has been a remarkable success, and I know that there are other market segments that are very focused on global competitiveness, but therein lies the difference between the securities' regulatory framework and legislation versus the very contemporary and modern legislation framework that was adopted in 2000. It works. It has advanced this industry. It has made us globally competitive with every other market sector in the world.

The difference is the SEC has got to catch up with the CFTC. This is a tweak, what we are talking about. This is a minor glitch in an otherwise great landmark legislation that has really promoted vitality and growth and competition in these markets.

COMMISSIONER SOMMERS: Thanks.

MR. DONOHUE: I'm not fearful of that flight to less regulated environments.

COMMISSIONER SOMMERS: Thank you.

CHAIRMAN LUKKEN: Commissioner Chilton.

COMMISSIONER CHILTON: Thanks, Mr. Chairman. Thanks, Mr. Krenkel, for your testimony. Dr. Newsome, I just wanted to thank you for your leadership and your work on CFMA.

Mr. Sprecher, I want to thank you for being so forthright. Congratulations on your success, and thank you for being both before the Senate and before us. I know you sort of feeling like you're the whipping boy on this, but thank you for being here and being so candid with us.

For Mr. Donahue and Dr. Sandor, I think maybe I'm missing something -- which happens often. It seems to me that you could just get rid of 2(h)(3) but then you allow the Agency to make exceptions and exclusions.

I mean, Dr. Sandor, for example, it seems that there are ECMs that don't rise to the look-alike level. If we could use this principles-based regulatory regime, if we can just go ahead and exempt people, why isn't that something that could be done? I'll go to Dr. Sandor first.

Mr. Donahue, I'm sympathetic to making it simple actually because I think it is easier to get something approved. One of the great mistakes I made was when I got here, I tried to read the act and got confused very quickly. So the simpler we can make the act, I'm in support of that, but I don't want to do something wrong.

Dr. Sandor and then Mr. Donahue, what do you think about that concept?

DR. SANDOR: Yes, I'm not so sure that Craig and I do differ or I may be hearing it differently. But from my point of view, certainly in the case of the Chicago Climate Exchange, one aspect of this is to make it simpler and exempt certain kinds of commodities and allow them to exempt. The Commission might have a set of principles.

I think it goes back to the prior statement about taking a shotgun approach as opposed to a rifle approach on this issue. There may be certain issues that we can address with the shotgun approach, different tiers, different principles, and achieve the social objectives. We probably all can sit down privately and figure out what those are.

MR. DONOHUE: Well, again, I mean I

think simplicity has its virtue. I would be loathe, I think, to see Congress move in the direction or the CFTC, if it had the ability to do so, move in the direction of creating several more tiers within a tier. I think that that will break down of its own weight very, very quickly, and I think that's not the right solution.

Again, I do understand the burden of starting from nothing and creating new markets and having the kind of flexibility to be successful in a much smaller environment, but where we're talking about manipulable commodities, I think that there is a minimum cost of entry and a minimum capitalization requirement that we need to be willing to say is necessary in order to facilitate transactions and commodities.

I don't care who the participants are. At some point, somebody gets hurt when there's a manipulation of a commodity market. And so, with all due respect to that, I think we also have to say if we are going to facilitate that, isn't there some minimum cost of entry that's appropriate for ensuring protection of customers, however sophisticated they might be and whatever the trickle-on effects are of their failure to other investors in the marketplace. So I think that that's important.

I think the other part of it is that you know better than I whether you actually have the regulatory authority to make exceptions or exemptions and whether that's an effective way to utilize the time and resources if you have the ability of the CFTC and its very scarce staff. So I think simplicity is useful here for that purpose as well.

COMMISSIONER CHILTON: That's actually a question I asked our --

DR. SANDOR: If I could make, sorry, one last point. I do understand the arguments that Craig is making, and I think for large commodities and manipulations, that may in fact be right. But not all commodities are large, and this is the only section.

I would bring to point and score the

point that Jeff Sprecher made. I, for one, was writing personal checks and starting this market, and it was all done with my own capital and friends and family. I can sincerely say to you that I was able to raise the capital based on an exempt market, and I probably would have run out of money if I would have had to go through the legal expenses, okay, and go through the regulation at the outset. We can do it now. That's not the issue.

But I'm wondering about those people who are beginning new markets and are not like Jack or Craig or Jim, who have tens of billions in market cap. Then resources aren't the problem. When you're Jeff Sprecher, who is an entrepreneur, and Richard Sandor, a million dollars is the difference between living or dying or a half a million or of 12-month loss of time.

And so, please do score the entrepreneurial viewpoint and the capital constraints associated with launching a new small business, and I don't think the problems arise with new small businesses.

COMMISSIONER CHILTON: Thanks, Dr. Sandor. We do have that authority, Mr. Donahue. That's the question I was actually asking earlier to senior staff.

If you're on Capitol Hill and you're Dan Berkowitz or you're somebody, you're Dawn Stump, and you're trying to figure out how to do this, how in the world could you possibly write legislation that can anticipate all these things in the future?

Senator Levin has tried to do that, but this is really complicated. Even if you get it exactly right today, it is different perhaps tomorrow. That's the beauty of this principles-based regulation that we do have and the ability to have this flexibility.

I'm not making a hard case for just getting rid of it and giving us authority, but it seems to me that that's something we should. I mean I think we have the authority and allowing us to continue to do that. It seems to me that there are ECMs that might not raise to the level of being fully regulated.

I don't know all the answers to it, but I think we do have the staff. I've never worked with a better group of people here.

For Dr. Sandor, I was just thinking, when you were talking about you may be like Caesar's wife. We certainly don't want these markets to end up like the last scene in Hamlet.

Thank you, Mr. Chairman.

CHAIRMAN LUKKEN: I think we have time for a few more questions. I just have a really quick one.

This is an interesting debate going on. I think everybody, in some ways, is trying to get to the same thing, which is rationalizing the risk of the marketplace to the regulatory structure. There's a variety of ways to do it, either stripping down a one size fits all category to fit the market or building up the requirements you need on a case by case basis as the CFTC might be able to do or through a category we could create.

So this is interesting.

We don't want to protect the Microsofts, circle the wagon around the Microsofts, though, and harm the Googles that may be developing in this marketplace. So that is at we are trying to optimize here.

Something I wanted to talk about was part of the advantages of being in the regulated spaces. Something we talk about a lot is recognition in foreign countries, of being able to compete overseas. One of the things that I think is an advantage of being a regulated entity under the CFTC is having a regulatory passport, being able to go to foreign regulators as a registered entity within the United States and allowing those foreign entities to recognize that and allowing you to operate overseas in regards to that recognition.

How important is that? Is that enough of a carrot to pull entities out of the ECM line or regulatory space into a designated space?

Are more carrots needed? There may be

tax advantages of being in a regulated space. Exclusive jurisdiction might be something that's interesting for people in the regulated space. Can you talk a little bit, instead of the regulatory requirements, about some of the advantages of being in the regulated space and how that might be useful for us going forward?

DR. NEWSOME: I'm going to save the exclusive jurisdiction comment. Maybe we'll have another hearing to talk about that one later.

I think certainly there are huge advantages to being a fully regulated DCM, many of which you just mentioned, Mr. Chairman, and that has been evaluated specifically by NYMEX. As we entered the OTC clearing space, we've set up joint ventures and subsidiaries, both domestically and in other countries. In every instance, we've always come down on the side of being a fully regulated DCM.

I think the access to the full array of customers certainly helps build liquidity when you're launching new products. There are arguments across the gamut. From the NYMEX standpoint, we believe in being a fully regulated entity, and we will continue to do so.

CHAIRMAN LUKKEN: Jeff.

MR. SPRECHER: It is kind of a mixed bag. I'd like to say that the world looks at the United States and says great, but unfortunately it is not quite the case.

I do think one thing that this Commission did a year or so ago by working with the FSA to put that communication agreement and cooperation agreement in place has really helped because it has brought, at least in the commodities area, us into a sort of footprint of global regulation where the U.S. will, in a way, have a strong hand in dictating the rules. I think between you all and the FSA, you've got an amazing footprint for exploitation of that.

We're unique in that we're a company that took a bilaterally traded swap contract and brought it into a cleared market that was an ECM and then eventually took it into a regulated futures market in our case in the U.K., and along the way the volumes grew. So it is very much. I have definitely have the experience that volumes can grow when you add more regulation.

Regulation itself is not a deterrent. In fact, it maybe the thing that really allows new entrants to have some confidence in the product. So on a product by product basis, we think about that. We don't think about it so much as a one size fits all on the corporate basis.

In fact, that particular product which was WTI, West Texas Intermediate Crude Oil, which happens to settle on NYMEX final settlement price is the same structure as the contract that a lot of us are talking about here, the Henry Hub swap which we have not elected to take into a regulated futures environment for a number of reasons, that we just don't think that it is really ready for that yet.

CHAIRMAN LUKKEN: Thank you. I'll turn to Commissioner Dunn. I know we are running short on time here but one last set of questions.

COMMISSIONER DUNN: I hear quite often that there will be unintended consequences if we would with one fell swoop get rid of the 2(h)(3), and I'm wondering what are those and what would happen. Would there be a flight to offshore?

Is there a competitiveness there that we would lose, a competitive advantage, by not having that and how do we ensure that those sophisticated operators that are really doing bilateral still have a place here and aren't going to go somewhere else as a result, because there is a cost to being an SRO?

MR. DONOHUE: Yes, I'll start with that. Just to begin with, I think that there's an unintended consequence effect in almost everything we choose to do, and so choosing to include 2(h)(3) in 2000 certainly has led to unintended consequences. I believe certainly in the energy markets with what we've witnessed.

So I think we can't focus on whether we can do something exactly correctly, knowing that the market will continue to evolve. I think we have to focus on doing something that seems mostly correct, and I really think that we really shouldn't be overly concerned with the unintended consequences.

Again, it seems to me there's been a lot of great evidence of successful innovation and incubation and development of new markets and new products in a regulatory environment. I think we should all remind ourselves as well that we are operating under a much different non-prescriptive oversight regulatory mechanism that allows people to bring products to market very quickly, relatively inexpensively.

We have an environment, as some of the people here have testified today, where you don't have to build and operate your own effective compliance and surveillance capabilities. It can be outsourced. There are lots of people willing to do these things on a reasonable economic basis, and I think it is appropriate to say that that's important for this country, to have that kind of regulatory integrity.

To answer your larger question, I mean certainly we think regulation is a great advantage, but to be fair and I always enjoy the opportunity to actually find a point of agreement with Mr. Sprecher, I think that it is true.

MR. SPRECHER: We both like the Board of Trade.

MR. DONOHUE: I think it is a great advantage beyond that. We like them at a higher price.

Beyond that, we think it is a great advantage for us, but I wouldn't be willing to sit here and say that it is such an advantage, Commissioner Lukken, that in all cases, everything ought to be very heavily regulated within the scheme of what's available under the CEA. Obviously, there are other markets, particularly non- manipulable markets, where an exemption from regulation is absolutely appropriate, and we wholeheartedly support that.

DR. NEWSOME: Commissioner, my thoughts, sir, I hope that I've voiced the viewpoint of the

New York Mercantile Exchange adequately with regard to this targeted approach. Craig, I think makes good arguments with regard to the viewpoint of the CME.

Our bigger concern for the unintended consequences is the even broader approach that some members of Congress are verbalizing with regard to the traditional bilateral OTC markets, and certainly we think that is unwarranted and unnecessary at this point. I think it would be hard to make the case that one, those should be regulated and, two, even if you chose to do so, how you would do it.

MR. SPRECHER: I have a couple of unintended consequence concerns that I'll try to distill into a soundbite. The biggest one, while I have some concern about things going offshore and one of the points we put out in our prepared testimony was in ICE's top five contracts, one of them is located in Asia and one of them is located in Canada. What we're really asking broadly is will the Canadian energy market and will the Asian energy market respond to oversight by the CFTC?

We all share the view of we don't want manipulated markets. Nobody who is in the transaction business benefits by market manipulation, but we benefit from market confidence.

The question is would we really have the authority to ask a Chinese airline to reduce jet fuel position and would they, and would we just get to make that call one time and then they're gone from our markets? It is fine-tuning that.

On the other hand, do we want Chinese airlines manipulating markets? I certainly don't on my platform. So you want some level of authority and standard which we've tried to embody in our own contract with people that use our platform.

The bigger issue for me is that while we've talked about Henry Hub, of the 1,000 different products that we trade, many of them I don't think we would want to say are sources of price discovery. I certainly wouldn't want to convey to people they should rely on these prices.

The energy markets have been deregulating over much of my lifetime, but there are natural monopolies in energy. In the natural gas market that we're talking about, there's 100 delivery points in the U.S. At the center of each of those delivery points is likely a natural gas utility that has a dominant role. It is not uncommon in that utility who's hedging with swaps to be half of the market. They're on 50 percent of every trade.

If we were to collectively suggest that the prices that they've discovered was the price of natural gas in Eugene, Oregon, let's say, and if the Eugene, Oregon public utility commission were to use those prices in setting rates for that utility or FERC were to use those prices in pipeline considerations or what have you, we'd create an odd situation where a small number of trades that are probably dominated by one party could take on a role that would actually lead to higher prices for consumers.

A lot of what we're talking about and a lot of what Dr. Newsome and I have been working on privately and at Congress are these large liquid pools that affect like the price of natural gas benchmark that we've all come to know, the Henry Hub. We had a similar debate on this WTI contract a year ago.

Where these OTC markets can directly affect futures markets, I don't see a problem and I don't see a flight overseas. I think those are natural U.S. markets and they're broad enough that the collective body of participants wants there to be a regulated or confident market, let's say.

CHAIRMAN LUKKEN: Commissioner Sommers, anything? Mr. Chilton.

COMMISSIONER CHILTON: I only had one question, and I wasn't going to ask this, but I'm curious.

Mr. Sprecher, have you all ever sent to us a referral for attempted manipulation or manipulation?

MR. SPRECHER: I can't say only because

my compliance staff, we've designed it to keep management out of the discussion so we don't mix commercial issues, and we do have those obligations. I do know that our staffs have been working to more tightly coordinate.

ICE is unique, again, in that we have all these physical markets that may generally be FERC-related, but we've now been seeing the interplay of the CFTC and FERC. So there's been a lot of dialogue between the collective staffs over where should we refer these things or both places.

COMMISSIONER CHILTON: You can go here.

MR. SPRECHER: I think your staff has a lot going on right now.

COMMISSIONER CHILTON: The only other thing I wanted to say is again, you know Commissioner Dunn gave big compliments to Dr. Sandor, and I echo those because I mentioned earlier maybe at some point in the future, that whole issue of carbon trading is something we can take a look at publicly. I think you're doing some enormously innovative things. The force be with you.

Thank you, Mr. Chairman.

DR. SANDOR: Thank you very much.

CHAIRMAN LUKKEN: Thanks, Richard. I want to thank the panel for their testimony here today. We are going to continue in about an hour. We will reconvene at 1:00. We appreciate everybody appearing today.

(Whereupon, at 12:04 p.m., a luncheon recess was taken.)

A F T E R N O O N S E S S I O N

(1:08 p.m.)

CHAIRMAN LUKKEN: Welcome back, everyone. We have a couple panels this afternoon to continue our debate on exempt commercial markets. Before us today, we have market users. I think they will be helpful in enlightening the debate on exempt commercial markets.

On the first panel, we have Russ Stolie who is General Counsel for the Huntsman Corporation -- welcome, Russ -- and Skip Horvath, President of the Natural Gas Supply Association. We have Laura Campbell who is representing the American Public Gas Association, but her full-time job is with Memphis Light, Gas and Water. Welcome. We also have John Damgard, President of the Futures Industry Association.

Thank you all for coming to testify. We will turn it over to Russ.

MR. STOLIE: Good afternoon, Chairman Lukken and members of the Commission. My name is Russ Stolie, and I am the Senior Vice President of

Global Public Affairs and Communications for Huntsman Corporation. I would like to thank the members of the Commission for the opportunity to participate in today's hearing on the oversight of natural gas trading on the regulated futures exchanges and exempt commercial markets.

With your permission, Chairman Lukken, I would also like to submit a written statement for the record.

CHAIRMAN LUKKEN: It is part of the record.

MR. STOLIE: Huntsman is a global business manufacturing and marketing what we call differentiated chemicals. Our operating companies manufacture products that are essential to a variety of global industries including automotive, aviation, textiles, construction, high tech, agriculture and health care. You'll find our products in many of the products you buy and that touch our lives every day from the shampoos in your shower to sophisticated epoxy curing agents that are used in the manufacture the wind blades that now populate wind farms.

Huntsman today has nearly 13,000 employees and operations in 24 countries and, in 2006, we had revenues from all operations exceeding $13 billion.

Global companies like Huntsman depend on the commodities market for critical raw materials and rely on fair pricing in those markets in order to be competitive both domestically and abroad. A key commodity for Huntsman as well as for thousands of other domestic businesses and millions of American farmers and consumers is natural gas.

Unfortunately, price volatility in the market for natural gas in the United States has made the U.S. Significantly less competitive for manufacturing operations that rely on natural gas as a commodity which has and, if not addressed, will continue to have a significant impact on employment in the manufacturing sector of this country's economy. Our company is one of many U.S. companies to have been competitively disadvantaged on the global playing field by this price volatility, and we believe our experience is representative of the experience of many others.

Beginning in the year 2000, our management began to conclude that ongoing volatility in the price of natural gas in the United States would likely be such that it would be necessary to both divest of those of our businesses that are most dependent on the consumption of large quantities of natural gas and to shift our investments overseas to countries less subject to significant volatility in the price for natural gas.

The global composition of our workforce followed suit. In the year 2000, approximately 37 percent of our company's then 10,400 employees were working in the United States. By the first quarter of this year, that percentage of our workforce that are U.S. employees had fallen to about 23 percent. By year-end 2007, only 18 percent of our company's roughly 13,000 employees will be located here, a greater than 50 percent reduction of that percentage of our global workforce.

While most of those reductions are the result of divestitures of certain of our U.S. businesses rather than actual plant closures, those divestitures were largely to an energy company that can integrate those assets with its own, and our reinvestment has largely been overseas -- in the end, a net loss of jobs here in the U.S.

Of the multiple new plants and plant expansions we have announced, only one of major significance is located in the United States. It happens to be an exothermic process that also produces a byproduct gas stream that rises in value with the price of natural gas.

If you were to look at Huntsman's use of its discretionary growth capital, meaning that used for new plants and capacity additions on existing plants, during the last three year and then include that which we have budgeted for 2008, you would find that roughly 78 percent of the more than $1.1 billion combined was or, in the case of next year's budget, will be used for projects located outside the U.S. If we include our expectations for 2009, that percentage is projected to climb to roughly 85 percent of a combined $1.6 billion for the years 2005 through 2009.

Our company strongly believes that price volatility in the U.S. market for natural gas is due to a failure of the current regulatory structure for the trading of futures on natural gas to serve the purposes of the Commodity Exchange Act.

Now, I'd like to share with you a few additional thoughts on why this volatility in the price of natural gas so significantly impacts Huntsman and the chemical industry overall.

The price of natural gas intersects our profitability at two major points. As you may know, while natural gas is largely comprised of methane, the market price of its sister molecules, ethane and propane, also rise and fall with the price of natural gas. Ethane and propane are the two principal raw materials for the chemical building blocks, ethylene and propylene, which we produce and then further use to manufacturer many of our other products.

We must buy huge quantities of ethane and propane almost every day to feed our ethylene crackers. Ethylene crackers are the mammoth manufacturing units that crack ethane and propane to produce ethylene and propylene. Because we consume such huge quantities of ethane and propane and because there is limited storage available for these gases, radical volatility in the price of natural gas means comparable volatility in the prices at which we purchase our two most major feed stocks throughout a given month.

Now, additionally, natural gas also serves as the fuel that fires the giant furnaces of the typical ethylene cracker which requires very high heat to achieve the necessary cracking of the ethane and propane molecules. As a result, volatility in the price of natural gas impacts both the cost of our feed stocks and the fuel used in our manufacturing processes, producing a two-pronged impact on our economic viability.

Now, a few comments on why companies such as ours cannot simply manage their way through periods of radical price volatility.

As I already mentioned, we are virtually at the mercy of the daily market for ethane and propane feed stocks. Additionally, we generally buy our natural gas for fuel on a monthly basis, fixing our price for the next 30 days based on the last three days of trading on the NYMEX in the previous month. We occasionally let it float for the month if we think that the price has substantially spiked during the last three days of the month.

But, on the other hand, our contracts for many of our products with our customers, to compete, we have to sell pursuant to contracts that often permit Huntsman to reprice no more frequently than quarterly. Even those of our contracts that permit more frequent repricing routinely provide that customers don't have to accept our announced price increases but can shop for alternate sources pursuant to a meet or release clause in their contracts.

When there is significant volatility in the price of natural gas, Huntsman must absorb or one might say act as a shock absorber for unpredictable spikes in our cost of goods sold to the extent we cannot pass on those increases in cost to our customers. We note that only yesterday, Bloomberg reported that natural gas has risen again because of speculation that hedge funds would be driving prices up higher. In other words, we got squeezed. It is this shock absorber effect that is driving many in our industry including Huntsman to invest in production assets in regions of the world with a less volatile natural gas market.

These economics played a major role in our decision to divest of our domestic stand-alone merchant market ethylene cracker to an energy company with a domestic upstream energy producing business, retaining only a smaller captive ethylene unit to produce ethylene for our own consumption. Though still somewhat subject to the problems I have described, we are significantly reducing our exposure to the domestic natural gas market.

We have found that attempts to fix the price we pay for natural gas for longer periods of time are ineffective for several reasons. First, we must pay a significant premium to lock our price for longer periods.

Second, our customers, with some exceptions, generally are unwilling to lock the price they pay for our products for longer periods for fear of having an uncompetitive cost position relative to their competitors should the price of natural gas decline, permitting their competitors to procure comparable products for less.

And, third, without such an agreement from our customers to fix the price they pay for our products for a period of time comparable to a long position we might take on natural gas, we incur unacceptable risk relative to production with access to a less volatile natural gas market.

While Huntsman applauds the Commission's enforcement actions and supports the Commission's recent proposals, Huntsman believes that these changes alone are not adequate to address the problems in the natural gas market. My written statement addresses our specific recommendations to the Commission to support amendment to the CEA and to take further regulatory actions in the natural gas futures market.

Thank you very much for the opportunity to be here today. Although I must leave soon, I would be happy to address any comments that the Commission may have. If there are any questions for Huntsman following the remaining panelists, with your permission, Chairman Lukken, I'd like Oliver Ireland to substitute in my spot and answer those questions.

CHAIRMAN LUKKEN: I understand you have a busy schedule, and we'll welcome Ollie to join us if he has to. So, thank you.

Now we'll turn to Skip. Thank you very much.

MR. HORVATH: I'm Skip Horvath, President and CEO of the Natural Gas Supply Association, the NGSA. Our members are large integrated and independent producers and marketers of natural gas. We're the guys that put the drill in the ground, get the gas out and get it out to the buyers around the country.

We operate in our market on three bedrock principles, and those principles are integrity of the market, transparency of the market and efficiency of the market, so, integrity, transparency, efficiency. If those were there, we wouldn't be able to do our job.

This year alone, we are investing over $160 billion in new assets, which is more than the previous year, the year before that. That has been true for about four or five years now and constantly increasing up to $160 billion. We would not be doing that if we didn't have confidence in the market. We know this market works. Now, because we feel these principles are followed, we can trust that the market is competitive.

You have to ask the question, why the volatility, which the previous speaker referred to. The reason for the volatility is our supplies are artificially constrained. We have areas of gas-prone lands that are off limits. I realize that's not the role of the CFTC. It is not your job, but you need to understand that while it is appropriate that you and Congress look at perhaps extending more oversight over energy markets, that will have a relatively small benefit compared to benefits you'd see from increasing supplies of natural gas. We feel those are the real concerns as far as volatility and price go.

But you do have a role. The CFTC and FERC both are, in no small part, reasons for why the market works so well. You guys are doing your job. You are the cop on the beat. We view the ongoing cases as proof that you're doing your job, and you are doing exactly what you need to be doing.

So I don't want to give the impression that everything is perfect and you can't improve. You can always improve the system. You need to consider what Congress is talking about, what you all are thinking about doing for extending regulation, but we ask that you do it prudently.

Let me give you some examples of what we think you all are doing right. FERC's policy statement in 2003 helped in price reporting to remove uncertainty in the market. The CFTC's memo of understanding with FERC and how you're working together, I can't tell you how much regulatory uncertainty that took out of the market and why it is so important for the market to understand that agencies are cooperating together. The EPAct of 2005 increased price transparency in the market.

We have over 7,000 producers, we have millions of buyers, and we have a competitive market. We have a role for speculators. Speculators help take volatility out of the market, contrary to the view of some.

As a result, the U.S. has the most competitive, robust natural gas market in the world. You already have the best market. I'm not saying you can't improve it, but it is already pretty darn good.

We've got some materials on this side of the room, a paper done by a professor locally about he feels natural gas is the best market in the world for transparency and competitive reasons. So I encourage that for your reading.

I am going to end on that thought because I just want you all to realize you are doing a good job and we do have a very competitive, well functioning market.

Thank you.

CHAIRMAN LUKKEN: Thank you, Mr. Horvath. Thank you very much.

We turn to Ms. Campbell.

MS. CAMPBELL: Thank you, Chairman Lukken and members of the Commodity Futures Trading Commission. I appreciate this opportunity to testify before you today, and I thank the

Commission for calling the hearing to examine the critically important issues of trading on regulated exchanges and exempt commercial markets.

My name is Laura Campbell, and I am the Assistant Manager of Energy Resources with Memphis Light, Gas and Water. MLGW is the nation's largest three-service municipal utility and currently provides services to more than 420,00o customers.

I testify today on behalf of the American Public Gas Association. APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states, and almost 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit retail distribution entities owned by and accountable to the citizens they serve.

APGA's members have lost confidence that the prices for natural gas and the futures in economically linked over the counter markets are accurate reflections of the supply and demand conditions for natural gas. Without question, natural gas futures contracts traded on NYMEX and financial contracts for natural gas traded on the over the counter markets are economically linked. Markets for financial and natural gas contracts is composed of a number of segments which include future contracts traded on the NYMEX and financial contracts for natural gas traded on the OTC markets.

OTC contracts may be traded on multilateral electronic trading facilities known as exempt commercial markets or ECMs. They also may be traded bilaterally on electronic platforms through voice brokers and indirect bilateral transactions between counter parties.

The impact of last year's activities of the Amaranth Advisors hedge fund exemplifies this linkage. When the positions accumulated by Amaranth began to unwind, gas prices decreased. Unfortunately, many of APGA's members had already locked in prices prior to that period at levels that did not reflect the current supply and demand conditions. As a result, elevated prices during that period when Amaranth held these exceedingly large positions, many of APGA's members were forced to pay a premium which was passed through to their customers on their gas bills.

The CFTC has done a good job in catching market abuses after the fact. However, the Commission did not have a complete picture of the full extent of Amaranth's trading position until after Amaranth's collapse. Greater transparency with respect to traders' large positions, whether entered into on a regulated exchange or on the OTC markets for natural gas, will provide the Commission with the tools to detect and deter potential manipulative activity before our members and their customers suffer harm.

APGA believe that there are immediate measures that the Commission can and should take within its existing authorities to improve the current situation. The recent proposed amendments to Rule 1805 offer the Commission both the means and the opportunity to increase transparency in these markets and thereby begin to address the current lack of public confidence in price integrity. Rule 1805 is a potentially powerful tool to shed light on reportable traders' positions in all segments of the natural gas market.

APGA believes that the Commission should use this authority aggressively to issue special calls to all reportable traders in natural gas for information with respect to their overall positions in all segments of the financially-traded natural gas market. This would be an important first step in meeting the purpose of the Commodity Exchange Act to deter and prevent price manipulation of any disruption to market integrity.

However, APGA also recognizes that Rule 1805 would only apply when a trader has a reportable position on a regulated futures market and that a large trader could therefore easily evade the reporting requirement. For this reason, legislation to enhance the Commission's authority by providing a comprehensive large trader reporting system that includes all segments of the market is necessary.

APGA strongly supports the Market Trust Act of 2007, introduced by Congressmen Baird and Graves. This bipartisan legislation would protect consumers by requiring the reporting of large positions in financial contracts for natural gas held in all segments of the market. It is important to note that the Market Trust Act is narrow in scope and applies only to financial contracts, agreements and transactions for natural gas.

Finally, APGA commends the Commission on holding this hearing and believes that greater public involvement would assist the Commission as the market in natural gas changes and as the Commission's policies necessarily evolve to meet the challenges of the new conditions in the energy markets and urges the Commission to establish an advisory panel on energy markets.

Natural gas is the lifeblood of our

economy, and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the prices those consumers are paying for natural gas comes out through the operation of a fair, orderly and transparent marketplace.

We believe that the Commission can do much within its existing authorities to increase transparency and to improve the current situation. Moreover, Congress can provide American consumers with the protections they deserve by passing the Market Trust Act of 2007.

Thank you.

CHAIRMAN LUKKEN: Thank you, Ms. Campbell. We turn to Mr. Damgard.

MR. DAMGARD: Thank you, Walt. Let me first congratulate the newest members of the Commission, Commissioner Sommers and Commissioner Chilton. I can hardly wait, Walt, to see that Acting come off your name. Congratulations to you.

CHAIRMAN LUKKEN: Thank you.

MR. DAMGARD: Not to ignore Commissioner Dunn whose steady hand has certainly helped agriculture through a very difficult period. For those of us that are enjoying the benefits of the high prices for commodities, I'm pretty happy, and Sara Lee and Wonder Bread probably are of the other opinion. Prices are meant to go up and down, and my view is that the CFTC has done a fine job in the past.

Anyway, Commissioner Lukken and members of the Commission, I'm John Damgard, President of the Futures Industry Association, pleased to appear before you at this important hearing on the oversight of trading in energy futures and other related derivative contracts.

FIA's member firms play many different roles in the trading and clearing of energy transactions both as intermediaries, principals, processors and end users. We have a substantial interest in energy markets and commend Acting Chairman Lukken and the Commission for holding this public forum to allow a full spectrum of the views to be heard.

Everyone agrees that the price of energy is a critical element of our national economy. For decades, energy futures have served our national interest by providing a means for efficiently managing and reliably discovering energy prices. The Commission should take pride in its effective oversight and stewardship of these markets.

In recent years, energy markets have experienced considerable innovation and increasing competition. Congress addressed these forces when it enacted the Commodity Future Modernization Act of 2000. CFMA allows different levels of regulation to apply to different forms of derivative transactions in different commodities that are executed in different ways. This scaled regulatory approach was designed to serve equally well the public interest and various commercial interests.

In FIA's view, the CFMA has worked very well for markets generally and energy markets in particular. Look at the competition. In energy, the CFMA has made it possible for new markets to compete with established exchanges. That competition has caused those exchanges to modernize through electronic trading or at least increase their pace of modernization. The CFMA has also encouraged innovative thinking by established exchanges in new trading platforms.

The result is that those trying to manage energy price risks and those willing to assume those risks now have more choices than ever before. The CFMA has sparked these positive developments without compromising the public interest including the vital interest of preventing price manipulation. The Commission continues to deploy a wealth of market surveillance techniques and an arsenal of enforcement weapons in its pursuit of what Chairman Lukken has labeled the Agency's zero tolerance of price manipulation.

Clearly, the Commodity Exchange Act and the Commission's regulatory apparatus continue to target price manipulation as public enemy number one. FIA agrees with that emphasis. Price manipulation should be prevented whenever possible and never tolerated.

Some have questioned how well the existing anti- manipulation defenses work when more than one energy derivative market exists. In FIA's view, multiple trading facilities like NYMEX and the Intercontinental Exchange today in energy only enhance the need for vigorous CFTC oversight. When trading occurs on multiple markets, it is even more important that CFTC market surveillance has ready access to all relevant large trader information.

This principle applies whether the two or more related markets are DCMs, DTEF, XBOX or ECMs. None of those markets would be able to survive or be expected to survey all relevant positions on its competitive trading platforms.

The Commission's traditional role as the exclusive regulator of futures transactions and markets actually compels this kind of comprehensive and vigilant multi-market surveillance approach. Multiple markets combined with multiple regulators would be a recipe for disaster. For that reason, in 1974, Congress granted the CFTC the extraordinary power of exclusive jurisdiction to make sure that only an Agency expert in futures pricing would cast its surveillance eyes on futures trading activities. At the same time, Congress wanted futures market participants to be answerable only to that expert Agency's judgment.

The Commission has, in the past, correctly made clear to its sister agencies -- the states, the courts and Congress -- that monitoring futures pricing is its exclusive statutory duty. It should continue to do so, not as a matter of turf but as a means of continuing to vindicate the public policy goals exclusive jurisdiction serves, including the avoidance of duplicative or conflicting regulation.

While some may talk of loopholes and regulatory gaps, the FIA believes the record shows that the Commodity Exchange Act's anti-manipulation foundation in the energy area is very strong. FIA does not believe any changes to the CEA are vital to the Commission's ability on a day-to-day basis to achieve its anti-manipulation mission. The statute works well, and the CFTC worked well with it. At the same time, we recognize that the Commission will take whatever steps it determines to be needed to update its regulatory approaches consistent with its statutory authority.

Our final point is a familiar one and a critical one. Price manipulation is public enemy number one because it effects both market participants and the public at large. Price manipulation can have a serious ripple effect in our economy and can hurt many innocent bystanders.

That is why Commission vigilance is so important. It is also why Commission regulation benefits not just market participants, but just as profoundly, non-market participants. For that reason, FIA continues to be opposed, vehemently opposed, to funding the CFTC through a transaction tax.

In our view, all taxpayers benefit from CFTC market oversight. Therefore, all taxpayers should pay for it. If the CFTC needs additional resources, the administration should request, and Congress should appropriate the necessary funds.

But imposing an arbitrary and egregious tax, it would be born most by those that provide the liquidity that allow futures markets to serve so many public interests is a bad idea whose time should never come. Thanks for holding this hearing and considering our views. And I'm happy to answer any questions.

CHAIRMAN LUKKEN: I thank the panel for their testimony. We're going to shake things up a little bit, and I'm going to start with Commissioner Chilton in our five minute rounds of questions. Commissioner Chilton.

COMMISSIONER CHILTON: Mr. Stolie, when people talk about dreaded consequences of having an ill-fitted Enron loophole fix, they raise a bunch of concerns, and I'm sympathetic to those concerns, but you're on the opposite side. You've already lost people, and you've gone overseas, because we haven't done anything to address this; is that correct?

MR. STOLIE: That's correct. I wouldn't say haven't done anything, but what -- the policy that's currently in place is, in our experience, clearly inadequate to sufficiently protect large industrial consumers and sufficiently motivate them to invest here.

COMMISSIONER CHILTON: So we're already seeing problems because of a failure to act, is that essentially what you're saying?

MR. STOLIE: Absolutely.

COMMISSIONER CHILTON: And in your written testimony, which is very good, by the way, and I commend you for it, you talk about how you think that we've gone to the limits of our regulatory authority to do things and it really is something that takes an act of Congress to change; is that also correct?

MR. STOLIE: Well, I'm not sufficiently well versed in the act or in the changes that are needed, perhaps the comment. Our perspective is, natural gas needs to be regulated like an agricultural commodity. It was likened earlier this morning to an interest rate, and it is in no manner an interest rate.

There is attached to our written statement a map of the world, and it clearly, in our view, demonstrates that there are regional markets for natural gas.

COMMISSIONER CHILTON: That's good, thank you. You know, this morning I talked about the examples that we've seen out there already with Enron and Amaranth and British Petroleum, and Commissioner Dunn often asked who's watching the store. And with particular regard to manipulation, this is a tough thing for us to catch. And he says -- Commissioner Dunn says, how many other times have there been, and you say this in your testimony that we haven't caught something.

MR. STOLIE: Sure.

COMMISSIONER CHILTON: And so it seems to me that this is something we need to move forward on. As I said earlier, for me, it is not a question of if, it is how we get something done. My time is up, so I'll stop now, and if we do another round, I'm happy to do it, but I'll defer.

CHAIRMAN LUKKEN: Thank you, Commissioner. Commissioner Sommers.

COMMISSIONER SOMMERS: I'm going to continue on a line that I -- a path I went down with the last panel, and I have a question for Mr. Damgard. When we talk about the different levels of regulation and the different levels that the CFMA gave us, a DCM versus an ECM, what are the global implications, if any, of greater levels?

MR. DAMGARD: Well, I guess I would agree with, you know, almost everyone on the previous panel, except Mr. Donahue. I think that the existence of more than one training platform has contributed tremendously to the incubation of all sorts of new and innovative ways to train, and it is really spurred competition. And if there's one thing that the FIA has always championed, it is more and more competition.

To the extent that those incubations can take place here and not some place else, we consider that to be very, very good. We think that competition, if it exists outside the United States and competes with existing exchanges in the United States, we think that's just fine.

And if it is more efficient to do business in one market, what that's done is, it stimulated existing markets to become more efficient. Certainly NYMEX proved beyond a shadow of a doubt that they knew how to compete. And there's a market, the energy market, where there's tremendous competition, and I would argue that it is a direct result of the fact that there were ways in which, in the specters of the world, were able to start markets that had been very successful and serving multiple customer needs.

CHAIRMAN LUKKEN: Commissioner Dunn.

COMMISSIONER DUNN: Thank you, Mr.

Chairman. I'm really struck, Mr. Stolie and Ms. Campbell, on your testimony here, because it really strikes, to me, to what the whole purpose of having futures markets all about and what we do at the CFTC. I mean we're here to protect price discovery function, we're here to prevent manipulation, and we're here to assure that we have an effective vehicle for risk transfer.

And what I am hearing you say, Ms. Campbell, is that your association, which are commercials, have lost confidence in the market place. And, Mr. Stolie, you're saying you've lost confidence to the point that you're picking up and leaving.

MR. STOLIE: Not entirely; those elements -- on a national basis.

COMMISSIONER DUNN: Mr. Stolie, you don't have the luxury of picking up and leaving, your customers are still here. What does that do for your folks that are responsible for doing a legitimate hedge for protection of a resource for the consumers that are out there? What are they doing this year after they felt they were burnt so badly last year?

MS. CAMPBELL: Many of our members are refraining from hedging at all, frankly, and that's unfortunate, because I know with business like -- in particular, we believe that the place for us to mitigate our price risk is through the markets, and really that's -- so that's why we are here and wanted to stand up and say we want these markets to be fair and transparent.

And again, from APGA's perspective, what we'd like to bring to the current framework, and we think the CFMA has worked well for our customers and for the members at APGA, that what we'd like to see is greater transparency within that framework to bring the confidence back.

You know, I mentioned in my opening testimony that we're accountable to our citizens, and frankly, we have to go back and justify to our customers why we are hedging, especially in a market place that is falling.

So this is something that is critically

important for us, to stand up and stand before our city counsel and say we believe in these market places and they are a true reflection of supply and demand forces.

CHAIRMAN LUKKEN: I'd like to pick up on that, because that's what I'm curious about. It is not only that our markets serve a price discovery function, but also risk management function. And, Mr. Stolie, you likened your markets to agriculture. Certainly, you know, if you look at the wheat markets right now, a fully regulated market, volatility is extraordinary in those markets. I know you're trying to minimize volatility, and we do things to try to prevent manipulation, but often times supply and demand causes volatility, and the futures markets represent a thermometer, what the temperature may be of supply and demand.

And so that's something we have to think about. And what I'm interested in, I guess, is there something unique to natural gas? Farmers have been hedging in our markets for 150 years, trying to stop volatility to hedge in, lock in prices.

Are people hesitant for some reason? Is it natural gas in particular? Is there something at Huntsman, is there a -- you mentioned a premium that seemed to be expensive. What is it that keeps, not just reacting to price discovery in our markets, but what prevents companies like Huntsman from actually getting into the market place and locking down a price so that they can compete in the United States and stay here?

MR. STOLIE: Let me comment on that. There is a cost to doing so. Of course, that is a factor in why we don't do it. But additionally, and I think this is different from the farmer you alluded to, the price for our products moves, it moves -- it can move frequently, and we are in a very competitive landscape, but we are unable to fix the price that we receive. And so if that being the case, and I think -- maybe that's the distinguishing feature, if we fix the price of gas, we're really just -- we're just placing a bet, right, we are not, and I know economists, but we are not engaging in a classic hedge.

So let me see if I can flush that out a little bit. If it were the case that we could fix the price for our products and then lock in gas or hedge for that same amount of time, right, then, yes, we could be taking steps to mitigate the impact of significant volatility, that's not the case.

So, as I mentioned, if we bet wrong, and our customers are able to basically come to us and say I've got a better price elsewhere, well, then our price of gas is fixed, our competitor may have placed a better bet, and instead of competing with them on the basis of how well we're running our respective businesses, we are competing on the basis of how well we respectively bet on the price of natural gas. Does that help?

MR. DAMGARD: With all due respect, that's business. I mean you're exercising your judgement every time you use the market if you're in that business, and you're exercising your judgement if you decide not to use the market. And I'm sorry that, you know, the airlines aren't here. Southwest Airlines is a classic case of having locked in their fuel needs for a year in advance while all the other airlines said, gee, we'll just operate at the vagaries of the market. You can be sure that those airlines are now employing people who are extraordinarily knowledgeable about how these markets work, and I'm sorry that they're not here today. And to hear that people are leaving our markets in droves doesn't comport with the fact that our volume is up 30 percent again this year, and we're growing at a compound rate of 30 percent.

So I'm not persuaded that there's anything wrong with these markets. I think the real market pros recognize that using these markets obviously involves exercising a judgement, but if you make a judgement and your competitor makes a judgement and your competitor has made the right judgement, I don't know who he sold out to, but the Koch industry boys are certainly doing just fine in the natural gas business.

So I mean I think that you just can't come to government and say price volatility is evidence of manipulation. Prices move for a whole lot of reasons, and it doesn't necessarily, in fact, hardly ever involves manipulation.

MS. CAMPBELL: If I may, I'd like to make a point there. When it comes to LDC's, it is really not a business decision, nor a bet. Really what we're trying to do is to lock in a price, to protect our customers, those prices are passed directly through to our customers, so we're there trying to protect those customers with that price, and if the price is artificially high, it effects my customer today, because they pay too much. If the price is artificially low, it effects my customer tomorrow, because we're not sending the right signals to the producers. So either way, we need to protect these customers from any type of price manipulation, ensure, through transparency, that we are really reflecting the forces of supply and demand.

MR. HORVATH: I just have two comments; one, on the OBC side -- does represent a lot of municipalities, a lot of towns, but they're also IOU, investor owned utilities, and they also tend not to hedge, but they tend not to hedge because the state PEC totally understand hedging to understand what you do for a living, and they either have no policy, which they say is neutral, but it is not, because no policy means that if you hedge, and you hedge not perfectly, you can get back on a prudence review and get hammered.

So the effect tends to be to reduce the number of hedges that LDC's make, so that's one point you have to keep in mind, when you see a lack of hedging, it is not just always the market, there's a difference between state and federal regulations that needs to be made aware of.

On the other side of the coin, my members are as much a part of this market as the two folks on either side of me and we do hedge, and that's -- hedge -- we do in the market, and the reason is -- and we have the same issue they have, it is price volatility, which as I said, is a result of constraints applied more than anything that any regulator is doing. So we do hedge, and there are plenty of people in the market who hedge.

On the industrial side, while there have been some exiting out of the country, I do think it is unfair, I don't think Russ is doing this, it is unfair to suggest that people fled this country because of natural gas prices, that's just -- that's just way too much of an overstatement. There are a lot of factors involved in this country. And, in fact, industrial demand for natural gas is roughly flat, and people are hedging in that sector.

CHAIRMAN LUKKEN: I just want to make sure -- and John's point is a good one with Southwest Airlines. It is an often cited example. They locked in at $26 a barrel for oil, and at the time, a lot of people were saying, well, you're idiots for locking in at $26. That's when oil was at 20 and below at times. It looks brilliant now, but you know, farmers do this all the time.

And what I wanted to make sure is, we're educating people enough, if they can use the markets, to encourage them, and part of this exercise is to build confidence in our markets and make sure manipulation isn't happening. But if there are utilities out there that could and should be hedging their prices, we want to help educate, work with FERC to bring those people into our market so they can lock in these prices. Yeah, Russ.

MR. STOLIE: If I may make one more comment, and then I do have to part. And I'll comment on the airline question, which is that if you're going to be in the airline business in the United States, you're going to be buying fuel here. However, as a general matter, capital finds its way to its highest risk adjusted return. You don't have to be here to be in the global chemical business.

So from the business of -- from the perspective of our industry and highest risk adjusted return, what I'm here to communicate, in part, is, we're making a decision based in significant measure on volatility, excessive speculation, and we believe manipulation of the U.S. natural gas market, that our highest risk adjusted return isn't here. So if I can leave you with that message, and I thank you again for the time.

CHAIRMAN LUKKEN: Thank you for your testimony. We have another round of questions, Commissioner Chilton.

COMMISSIONER CHILTON: Let me just ask a quick one, if that's okay.

CHAIRMAN LUKKEN: Sure.

COMMISSIONER CHILTON: I'm pleased to see that the airlines are making a little bit more money. Maybe if they are able to hedge in the future, they'll be able to add some more tellers and Mr. Stolie won't have to leave so early. Ms. Campbell, I'm curious whether or not you'd be satisfied if Congress did what I was sort of talking about and just got rid of the multi-laterals, just address that issue, and then regulatorily, the agency would deal with the bi-lats; would that be something that you all would support?

MS. CAMPBELL: And when you say that, you're saying deal with --

COMMISSIONER CHILTON: Get rid of the Enron loophole 2(h)(3) --

MS. CAMPBELL: The 2(h)(3)?

COMMISSIONER CHILTON: It is gone.

MS. CAMPBELL: You know, I haven't really given you a full flavor of how we've used the ECM, so if you would let me do that. And primarily, as I heard Mr. Shilts earlier, their growth as a market has really mirrored our use of them as a market. Just a few short years ago, well, as a practical matter, we have about two and a half hours every morning when we have to decide how much gas we need that day and to buy it and then be ready to nominate and schedule it.

And that time we used to call dial and smile. We would call up as many people as we could and find out the price. And now we just sit in front of an ICE screen, and we have so many different choices, and I, as a manager, am able to overlay that with our credit strategy. So it is been really a very valuable tool. We've been able to not only be able to look at and serve our customers, but then beyond that, of course, we have excess capacity that we've been able to work with and do a lot of savings through that because we have the extra time to really look at the full picture through ICE.

So when we talk about ECN's, just the price discovery feature of that has really fundamentally changed the way that we buy gas. So I would really be hesitant to get away from that. Now that we're into cleared markets and that type of thing, now we've kind of crossed the line, so now we're into the part of our business that is hedging, and we handle that separately than we do the physical side.

So that's been typically done through the NYMEX, however, we have been monitoring, and now we will be able to clear trades through ICE. So now those two entities look very much the same to us. We'd be looking at both of those, they provide us an extra data point, so to speak, but they are fundamentally working the same, so that is my -- we feel very strongly there needs to be that transparency, that same level of transparency that we had on the DCM that's applied to the ECM. That way we can get that confidence back, and that way we'll -- all of our members will have -- we can bring them into the fold where they are hedging and meeting the needs of those customers.

MR. STOLIE: Do you want to speak to that question?

MR. DAMGARD: I mean I could lose my job, because the FIA is totally funded on the basis of member firms conducting business on designated regulated exchanges. And if you got rid of the so called Enron loophole, which I refer to as a loophole, it would be forcing everybody to do it on an existing exchange, and that would be very good for the FIA dues base.

Sprecher doesn't even use intermediaries. I, for the most part, represent the big intermediary firms. My own view is, to do away with that would run the risk of eliminating opportunities for new entries to compete.

And the ability of Sprecher to come in and compete with NYMEX has been extremely good for the end user because they are now competitive markets where competitive markets didn't use to exist.

And I thought they all made, starting with Doc Sandor, I didn't know he knew Caesar's wife, but he's been in the business a long time, he made a very, very valuable point in that these incubation periods for new kinds of trading and new kinds of markets and none of us even imagined when we went through the Modernization Act in 2000, for the most part, have been tremendously valuable for not only my members, but also for their customers, the end users.

COMMISSIONER CHILTON: Well, I'll just make a quick comment and I'm done then, Mr. Chair.

That's a great point, John, and again, I keep thinking, what is it that I'm missing, that if you just got rid of a 2(h)(3), but you allowed the regulatory flexibility for the agency to say, fine, that's an incubator, or the Chairman has talked about, you know, some graduation level, where it does become significant, this is something that we should worry about, but you know, I'm curious, in general, we can talk about it later, why would that be a problem?

MR. DAMGARD: I mean you can decide where to -- I mean I'm with Laura, I think transparency is terribly important. I don't mean you run an ad on the Wall Street Journal, but I think the Commission and the experts on the Commission need to have all the information that they possibly can across these competing markets.

And to Henry Hub, it is too bad Henry is not here to testify, because we talked about him a lot today. But it seems to me there was one market where there was a conclusion that that market was so close to an existing regulated market that the CFTC with current authority could go in there and demand regular reporting and disclosure, et cetera, and if that's what Laura wants, then we're for that. But we're not for that for eliminating the category, which would then effect all these other markets that are attempting to get to the point where the Henry Hub is today. Thanks, Mr. Chairman.

CHAIRMAN LUKKEN: Thank you, Commissioner Chilton. Commissioner Sommers, nothing? Commissioner Dunn.

COMMISSIONER DUNN: Well, as much as I'd like to continue along that line, I think I'll move somewhere else. Skip, you and John both talked about -- well, John talked about jurisdictional oversight, and you talked about the MOU with the FERC and CFTC. I'm curious to get your impression, and the rest of the panel, as well, on this. How can the CFTC and the FERC work better together to ensure that we have a better market place?

MR. DAMGARD: Do you want me to take

that? It is easy.

MR. HORVATH: I agree it is easy.

MR. DAMGARD: I think that the CFTC has exclusive jurisdiction because you have the life long experience in how markets work, and this is new territory for FERC. And it seems to me FERC could take the position that the states have under the model code. If the states find something wrong, and they think it is a violation of the Commodity Exchange Act, they should come to the CFTC, and together, you could bring that case. What doesn't make any sense is two separate standards. I mean the people in these markets need to know what the rules are, and if there's a separate set of rules from two separate regulators, that's extremely destructive to the business. And I recognize that FERC has a wide area of responsibilities about which the CFTC knows nothing, and maybe I'll let you speak to those. I don't know what they, you know, they know about the quality of fuel, it is moving through the pipelines, and they probably have to worry about breakages, et cetera.

I mean I don't know exactly what FERC does. But markets are your baby, and they don't understand markets, and you guys do, and it is important that the CFTC stands up and says, we want to work with you, we'll cooperate to the end of the world, but as far as the markets are concerned and as far as the Commodity Exchange Act, read the law. Exclusive jurisdiction was granted to the CFTC for all the right reasons, it is worked extremely well since 1974, and to me, it is the backbone of the agency.

MR. HORVATH: I agree it is easy, but maybe for slightly different reasons. This happens all the time. Congress -- I would expect to have two agencies mesh exactly so that jurisdictions just hush, but don't overlap and don't leave a gap.

It is impossible to ask that of Congress, and it happens all the time. So what do people do? They work it out among themselves, just as you all are doing. I know the folks at

FERC, they're reasonable people who I've seen here today, you folks are reasonable people, they'll work it out. So that's the short answer to that one. As far as what FERC does in markets, yeah, you know, you actually have a couple of good ones right, but they are -- what we learned today -- I learned something today that just sort of really surprised me.

There are people who will set their interest rate based on natural gas contracts. That surprised me. Okay. So that tells me there's a lot more innovation and creativity in the market than anyone thought possible. And certainly then Congress thought in 1938 with the Natural Gas Act.

So it is not expected, I don't think, that these regulatory jurisdictional disputes be forever settled or forever harmonized, because they constantly shift as the market creates new things. So the important point is, don't worry about that, just good people get together and figure it out, and I have every confidence, by the way, that you'll do that.

MR. DAMGARD: I have an example. Single -- with multiple regulators. These products are incredibly successful all over the world, but not in the United States, because the FCC has a different standard, and in many ways a different mission than the CFTC. So single -- continue to languish in the United States and we see those markets booming in places like Spain and Italy and Great Britain.

MR. STOLIE: Can I make a couple of observations? One, where you have two agencies with jurisdiction, and it is been described, you can have overlaps and you can have gaps, and I think gaps are a bigger problem than overlaps. Overlaps, you can work out with the other agency, gaps, you may not be able to fill and people may get through, so you want to make sure there are no gaps.

Second of all, I do think you read the Commodity Exchange Act and it envisions that the commodities markets will serve as price discovery vehicles for the physical market. And I think the role of the Commission is to make sure they're serving that function.

Our concern is, they're not serving that function as well as they might in natural gas. Other commodities are a different story. We think the CFM is a good idea and has sparked a lot of innovation, we're all for innovation, we're just concerned with the way natural gas has evolved. Nobody could have foreseen, and we need to go back and look at ways to address the volatility in that market and whether or not it is actually providing good pricing data.

CHAIRMAN LUKKEN: I had a question in regards to how users of the markets benchmark -- we've been talking about the natural gas NYMEX benchmark today, and it seems to me that a lot of the utilities and others that use that as a benchmark look at the last half hour of trading, where there can be a lot of volatility. And in the past, utilities have used either a moving average or a longer period of time in order to benchmark their pricing, which might help smooth volatility. Has there been discussion among the users of the markets of whether the model in which they benchmark currently is the right one?

Do you lose hedging abilities when you do that by smoothing volatility? What are the trade-offs, and is there some way we can work together, the users and FERC and us, to figure out if there's a better way of benchmarking in this area?

MR. STOLIE: We've had -- the Huntsman problem has been that we have to buy gas products on one side and sell products on the other side. And so we're looking at prices on both sides of ourselves. And if we lock in prices on one side of the market, unless all our competitors are locking in at the same place, there's going to be a difference in how that translates into our cost of doing business, while on the other side of the market, we have not been able to negotiate fixed price contracts without escape clauses, so that what happens is, the buyers on that side of the market go to the competitor who happened to manage to lock in at a lower price, if you tried to lock in, or priced at a lower price, and that just produces a difficult climate to do business in the United States, and it is easier to do it elsewhere. To the extent that that volatility is due to fundamentals of supply and demand, so be it, and maybe we have to go elsewhere to get less volatility. To the extent that that volatility is due to market problems such as manipulation or excessive speculation, we think that's a problem and we think the Commission needs to look at that.

But we've tried various pricing mechanisms on the buy side and tried to negotiate pricing mechanisms on the sell side to deal with that, and if we had to be here like an airline would be here, we'd live with it, and so be it with our competitors. But the plain fact is, it is making -- the volatility is making the U.S. a less competitive place to produce the kinds of chemicals that we're in the business of producing.

CHAIRMAN LUKKEN: Mr. Horvath.

MR. HORVATH: Yes; I understood your question to address, sir, the structure of our industry and --

CHAIRMAN LUKKEN: How you reference prices in our market.

MR. HORVATH: Right; those grew out, historically, out of the industry, so with the bid week of five days, the use of the monthly index, the daily index and that sort of thing, I mean you have to understand that going back to 1938, we used to have a 20 year reserve rule, so producers needed to have -- show 20 years of reserve on the ground before they were allowed to enter the market back -- regulated after the 1954 -- I don't want to bring up too much history here, but there's a rich history here. And over time, as Congress saw that that was an error, we were regulating too much of the industry on the physical side of the market. All the rules of thumb changed. And what we have now is, in a sense, the result, an organic, if you will, grew out of the market place.

What happens when you have a whole bunch of regulations you shouldn't have had and you start peeling it away one by one, in 1989, when we have the -- Control Act, was sort of the biggest -- that Congress did, and followed by FERC in 1993 with the 636 that took out the merchant function from the pipelines.

After that, there was a strong conversion to the system we have now, which is the one you see. So that was a long answer to your question. The short answer is, no, we have not look at an industry, at redoing it, because it seems to have grown organically out of what we had. Not saying it is the best system, but it is going to take a shock to the system that none of us sort of see necessary right now to change all that.

MS. CAMPBELL: You know, from NLGW's perspective, what we do is usually enter into a swap that gets us directly to that future's position, and then once we have that future's position, that's going to tie us back to positions on the physical side. But really, I think from APGA's perspective, we do feel like there's more need -- there's a need there for further review of benchmarking, and certainly that would be a good avenue for an advisory committee.

CHAIRMAN LUKKEN: It is something, as John mentioned, a lot of us aren't familiar with the history of how these -- FERC and all their issues, and we're familiar with our own Act, and in some ways how our markets have developed and how your markets are utilizing our markets, there's not necessarily a match there.

And so I think we need to both look at what we need to do from our end, but also maybe there's a way that the users can also look at ways to smooth volatility through how they benchmark. I think it would be an interesting question to, as you mentioned, an advisory committee, possibly. Thank you. Are there any other questions?

COMMISSIONER CHILTON: Just make a quick comment.

CHAIRMAN LUKKEN: Sure.

COMMISSIONER CHILTON: I just wanted to respond to the discussion about exclusive jurisdiction, and really notwithstanding the FERC issue, Mr. Damgard. I agree with you with one caveat. I mean I was talking about earlier how I was reading the act, and then it got too complicated for me, but it didn't get complicated by page 29, where you can find the Commission shall have exclusive jurisdiction. But it is not just important, and again, notwithstanding the FERC stuff, it is not just important for that reason, it is important for our credit events, for Forex, and for the foreign security index futures products. And that, along with this principals based regulatory regime that we have, really does make us different from the SEC, it makes us different from everybody else in government, and it is something that makes me excited about working here, and it is something that I think has been helpful to the industry, and as I said earlier, consumers also. Thanks.

CHAIRMAN LUKKEN: Thank you very much.

Well, I think that's all of our questions. I want to thank the panel for testifying. We appreciate all your help. And we'll convene the fourth and final panel.

(Recess)

CHAIRMAN LUKKEN: I think we're getting ready to begin. Mr. Zerzan, if you're in the building. There he is, okay. Our final panel today is market users. I would note that based on Commissioner Dunn's previous statement, the Fed has cut rates by 50 basis points today and the markets are up 200 points. So thank you, Commissioner Dunn, for helping out America.

For the final panel on exempt commercial markets, we have a very diverse set of participants. And to begin with we have Mark Cooper, who is the Director of Research at the Consumer Federation of America. Welcome, Mark. We have Greg Zerzan, Counsel and head of Global Public Policy at the International Swaps and Derivatives Association; Jack Gaine, head of the Managed Funds Association; and last, but not least, Sean Cota, who's President of Cota and Cota, but also represents the Petroleum Marketers Association of America. So welcome, and we'll begin with Mr. Cooper.

MR. COOPER: Thank you, Mr. Chairman, and members of the Commission. I appreciate the opportunity to appear before you today on an issue of vital interest to consumers. In May of 2006, I prepared a report on natural gas for the Attorneys General of Iowa, Illinois, Missouri, and Wisconsin, which included that structural and behavioral problem in commodity markets, particularly the lack of regulation of trading allowed by the Enron loophole, has influenced the price of natural gas in a volatile and upward direction.

I choosed (sic) the word "implements" purposefully, because the concept of manipulation is far too narrow to describe the problem in energy commodity markets or to prevent consumers from being abused.

At the time, federal authorities were in full denial mode, similar to the period in late 2000, when regulators insisted that nothing was wrong with the California electricity market, and Enrol was the darling of the commodity world. Less than two years later, Enron was in bankruptcy, and dozens of cases of abuse were turning up, but the Enron loophole remained in law and regulatory practice. Interestingly, in the 18 months since my report to the Attorneys General on natural gas, several reports from Congressional committees, private consultants, and even the popular press have echoed my findings.

The Enron fiasco has underscored either how little regulators knew about what was going on or how little power they had to prevent it. Ironically, the Enron loophole has continued to afflict American energy consumers long after Enron has disappeared.

The problem is clear, if you cannot see what is happening in all the major interconnected markets in which the commodity is traded, you cannot know what is going on. If you do not have the power to regulate all of the major commodity markets, you cannot stop abuse. Efforts to influence the price will be invisible to you or beyond your regulatory powers to prevent.

Thank -- oversight, that is the effort to glean activity in unregulated markets by its reflection in regulated markets as people lay off risk simply result in an imprecise and distorted picture. The solution is equally clear. Regulators need direct oversight. Large traders should be required to register and report all of their transactions in all the U.S. Markets that can influence the price of a commodity. If large traders are unwilling to register and report their activities in the U.S., they should not be allowed the privilege of doing business in the U.S. These are physical commodities that flows and settle in physical markets here in the U.S. If they don't like it, they don't have to do business here. Because the information will be confidential to the regulatory agency. It will have no impact on the market functioning in any way except to scare the bad guys away.

This single step will significantly discipline unsavory behavior. As we observe with private natural gas reporting services, even the hint of oversight scares the bad guys away. Unfortunately, in the case of the private services, they have failed to discipline people and require them to report. Federal regulators must have mandatory registration in reporting.

There is more, however; in the case of a commodity like natural gas, which has numerous characteristics that make it quite vulnerable to influence, such as high transportation and storage cost, low elasticity of supply and demand, highly seasonal to consumption patterns, and end users who simply cannot tolerate the physical risk of going cold in the dark.

There are many other steps that commodity exchanges should take to reduce excessive speculation and the potential for influence. A commodity like natural gas does not need to be transacted 20 or 30 times between the well and the burner tip. It is a physical commodity. Efficient allocation does not need that many transactions. These transactions raise cost, increase risk, and increase volatility. The Senate sub-committee on investigations has found clearly, residential rate pairs have not benefitted from all these wonderful, new products that they tell us have come into the market. Our prices have been increased, not reduced, as a result of them.

Strict position limits, both during and before settlement periods, longer settlement periods, higher margin requirements, strict accountability rules, and smaller allowed price wings will restrain excessive speculation and reduce the risk of influence.

We should regulate these at least as closely as we do other commodities because they are more vital to the every day life of American households and industries. From Enron to Amaranth, American consumers have been afflicted by the Enron loophole. Dozens of enforcement actions have failed to discipline manipulation, excessive speculation, and influence over price.

After the fact enforcement has not cleaned up energy markets now, five years after the first evidence of abuse, simply because the commodity is so vulnerable to influence that it invites abuse. For these special commodities, an ounce of prevention is worth more than a pound of cure. It is time to close the loophole and protect consumers. Thank you.

CHAIRMAN LUKKEN: Thank you very much, Mr. Cooper. We'll turn to Mr. Zerzan.

MR. ZERZAN: Thank you, Mr. Chairman, and members of the Commission. This discussion comes at a time of continued dynamic growth, both the exchange trade and over-the-counter business, and congratulates the Commission for its continued leadership in promoting fair, free, and competitive derivatives markets.

-- represents participants in the privately negotiated derivatives industry and is the largest global financial trade association by number of member firms. We have over 810 member institutions, from 56 countries, on six continents.

Recently, activity in the energy markets has caused some to question the current legislative and regulatory framework.

Under current law, the Commodity Exchange Act affords the opportunity to choose the type and level of regulation desired.

This choice is available both to entities in the business of hosting transactions, as well as to market users themselves, who may select what level of regulatory oversight they seek for their transactions. There is no question that from a purely quantitative prospective, these changes have been an unqualified success. NYMEX's average daily volume for crude oil and natural gas have increased by 90 percent from 2001 through 2006. Over-the-counter commodity derivatives, meanwhile, grew by over 850 percent from December, 2001 to December, 2005. Despite the tremendous growth these markets have enjoyed, some end users have complained that they are subject to manipulation and that the underlying prices which end users pay are distorted.

However, strong and statistically sound evidence backing these assertions remains wanting. In those cases, where some unscrupulous actor has attempted to manipulate the market, punishment has usually been swift and severe.

Ultimately, the price of a physical commodity is determined by the inexorable forces of supply and demand. Attempts to distort this are usually transparent, short lived, and to the detriment of the actor who tries.

When considering whether or not to modify the current legislative and regulatory system, it is important to have a proper framework for determining whether such actions are warranted and in the best interest of the market's end users.

In Europe, the European Commission operates under the federal regulation strategy. As stated by European Union Commission, Charlie

McCreevy, his approach demands that regulators first ask, has there been a market failure, and if so, is government intervention the best way to address it.

The European strategy is important to bear in mind for two desperate reasons; first, it articulates a clear methodology for approaching public policy; second, as the Commission is well aware, we live in a time of highly competitive global markets. This competition applies equally to markets themselves, as well as the countries seeking the economic benefits such markets bring.

It is thus a useful exercise to apply Commissioner McCreevy's formula to the question of whether current law bears changing. Applying the first test, has there been a market failure. Notwithstanding the assertions of some industry end users, there does not appear to be a strong supporting case for the existence of a market failure.

At the very least, in considering whether to change the existing framework, policy-makers should conduct a thorough and comprehensive examination of this question. The competitiveness of the United States as the leading source and location for the financial services industry is threatened now as perhaps never before.

When considering whether statutory or regulatory changes are necessary, the Commission should consider whether the cost of any proposed changes outweigh the perceived benefits. The derivatives industry is, without question, one of the outstanding success stories of U.S. financial innovation, in no small part because of the prudential leadership of the Commission. That leadership is now needed as much as ever. -- demands that the CFTC undertake the following actions with respect to exchange traded and OTC derivatives; first, the Commission should continue to seek to reduce unnecessary burdens on both exchange traded and over-the-counter energy derivatives. In order to ensure market participants are allowed to access different products and markets with maximum efficiency and minimum cost.

Second, the Commission should undertake a thorough study of all available evidence, including academic research relating to the relationships among the over-the-counter, exchange traded, and physical commodity markets.

This inquiry should be directed towards determining whether, indeed, exists a market failure in the energy markets. If necessary or beneficial, the Commission should propose that the President's Working Group participate in this project.

Third, to the extent the Commission finds evidence of the existence of a market failure, the Commission should undertake a thorough cost benefit analysis in order to outline the most narrowly tailored, least burdensome approach to addressing any clearly identified market failure.

Finally, the Commission should continue to forcefully reject efforts to increase regulation of the commodity markets in the absence of clear and convincing evidence, and any such change to the status quo is warranted from both an evidentiary and a cost benefit analysis. Thank you very much for allowing us to present our views, and thank you for your continued leadership.

CHAIRMAN LUKKEN: Thank you very much, Mr. Zerzan. Mr. Gaine.

MR. GAINE: Thank you, Mr. Chairman, and members of the Commission. My name is Jack Gaine, I'm appearing today as the President of Managed Funds Association, commonly known as MFA. It is always a pleasure for me to return to the Commission. In fact, looking back, I think I started work here August 1, 1977, roughly.

Since then, I think the Great Russian Grain robbery had occurred, and we had soy beans, and silver, coffee, and a lot of -- the Governor of Iowa I think wrote me as General Counsel saying that short selling in corn should be forbidden because there is far more open interest in short corn than there is in the yearly crop. So some of the issues here are not new to any of you who have followed the CFTC and the Commodities Exchange Act, and I'm delighted to be here and be part of it.

So FMA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, funds the funds, and manages futures funds. It is estimated that our members represent the vast majority of the largest hedge groups in the world and manages a substantial portion of the $1.67 trillion in the alternative -- absolute return strategies. We have a strong interest in the issues you are discussing today. Energy markets and energy derivatives are of increasing importance to our national economy and to market participants world-wide.

MFA members trade on exchange and off exchange. We're neutral in any competitive battles that pit traditional exchanges against new trading platforms or multi-lateral systems against bilateral dealer operations. Our members simply want access to efficient transparent and fair ECM, police, SEC -- and financially secure markets.

MFA's interests have been well served by the excellent work of the Commission and its staff for many years. Our interests have also been well served by the Commodity Futures Modernization Act of 2000.

In that statute, Congress adopted a cascading regulatory approach with different levels of oversight assigned to trading in different categories of commodities, market participants, and order execution facilities.

The Commission has been masterful in applying these new statutory provisions to allow new market forces to compete with traditional exchanges in a host of areas, especially in energy. FMA members have benefitted from these innovations, and when our members benefit, the investors benefit, and I think the liquidity of the capital markets benefit. MFA does not see a need for major changes in the CFMA. No case has been made to turn back the clock by reregulating new trading platforms that have served an incubator function for derivatives trading innovation. The CFTC's web site has listed 19 ECM's that have been created since the CFMA was passed. Those markets operate as principals only, many to many, electronic trading venues for its sophisticated, well capitalized market participants.

MFA believes that it is both appropriate and important to cultivate those innovative enterprises. In that score, the carve-out is very similar to what, in the securities law, Sections 3C1 and 3C7 of the Investment Company Act carve out certain funds from the definition -- for being registered and regulated as an investment company by virtue of the institutional nature of the investor population.

Less regulation does not mean no regulation. The Commission retains, as it should, the power to place price manipulation on ECM's. This power is vital, especially when an ECM offers a contract that is linked to the settlement price of a physical delivery contract traded on a DCM.

MFA supports the CFTC's work with ECM's and others to obtain access to all relevant surveillance data so that it may police effectively the U.S. futures markets. Let me close with yet another historical observation. When the Commission was created in 1974, Congress entrusted it with exclusive jurisdiction over futures markets to make sure that no other agency, whether it be the SEC, USDA, or the Bureau of Mines, would look over its shoulder and second guess its regulatory judgements.

Congress wanted an agency expert in futures trading to determine whether a threat of manipulation existed or some other major market disturbance caused futures markets prices not to reflect accurately the forces of supply and demand.

Congress vested extraordinary emergency powers in the Commission to address any such threat, powers of the Commission once called the lynch pin of the act. The Commission has correctly used those powers very sparingly, but their existence serves a very important purpose.

Exchanges and market participants alike know that the CFTC alone is ready to act when its informed expert judgement action is warranted. That power cannot work if it is shared with other regulatory bodies either at the federal level or the state level.

Nor can more than one agency police price manipulation in futures markets themselves. Otherwise, exchanges, intermediaries, advisors, funds, and other market participants will find themselves facing, at worst, conflicting, and at best, duplicative government regulation, the very ills Congress sought to cure with exclusive jurisdiction. Multiple regulators sharing concurrent jurisdiction will not strengthen regulation, it will just water it down through confusion at a considerable cost to market participants. MFA encourages the Commission to assert vigorously its jurisdiction as Congress intended and the courts have so interpreted. Thank you for this opportunity to appear today. I'd be happy to answer any questions.

CHAIRMAN LUKKEN: Thank you, Mr. Gaine. Mr. Cota.

MR. COTA: Honorable Acting Chairman Lukken and Commissioners Dunn, Sommers, and Chilton, thank you for the invitation to testify before you today. I appreciate the opportunity to provide insight as both a petroleum marketer and on behalf of two trade groups representing motor fuels and heating fuels dealers nation-wide.

It is ironic that you're hearing today as a day where crude oil is traded at a record high of $81 and change, so hopefully this is a pivotal moment.

First, we'd like to congratulate both Ms. Sommers and Mr. Chilton in their recent Senate confirmations. Congratulations are also in order for Mr. Lukken's recent nomination as Chairman.

We are encouraged by enforcement activities and we look forward to working with you on the Commission and the United States Congress to continue to evaluate the need for new oversight and new partnerships with key market players from energy traders down to the American consumer. I currently serve as the Petroleum Marketers Association of America, as its Northeast Regional Chair.

PMAA is a national federation of 45 states and regional associations representing 8,000 independent fuel marketers who collectively account for approximately half of the gasoline and almost all of the diesel fuel consumed by motor vehicles and heating equipment in the United States.

I'm also President of the New England Fuel Institute, a year old regional trade association located outside of Boston, and as such, I'm representing over 1,000 fuel dealers located in the northeast.

NEFI members deliver approximately 40 percent of the nation's home heating oil and market other products like bio- diesel, bio-heat and et cetera. I'm co-owner and president of one of those companies, Cota and Cota of Bellows Falls, Vermont. We are a third generation family owned and operated home heating fuel provider in Southern Virginia and Western New Hampshire. And unlike larger energy companies, most fuel dealers like me are small second and third generation family run businesses.

Also unlike larger energy companies, heating fuel dealers deliver directly to the American consumer in small homes and businesses, and therefore, we've developed a close relationship with those folks. The average fuel service company provides -- fuel service provider has approximately 30 employees and 4,000 heating oil accounts, delivers approximately 3.3 million gallons per year, those selling propane average 2,000 customers and 800,000 gallons per year in sales. In a survey of our associations, member companies have said that their most -- their highest priority is greater transparency in accountability and energy commodity markets due to volatility, and that that should be an ongoing public policy concern because we hedge directly for the consumer and the consumer is immediately impacted by these trades.

Because of our hedging activities, we strongly support the exchange of commodity futures in an open, transparent, and well managed exchange subject to the rule of law. It is essential to businesses like mine. I utilize energy hedging programs and NYMEX based trades on a daily basis in order to hedge for my consumers.

My company began offering fixed programs to our consumers 20 years ago. It is common place at my company and many others to do these NYMEX based contracts with our suppliers who purchase these contracts for future delivery and mark them up to me for profits. In my company, we aggregate all of our consumers together in order to come up with a minimum hedge in order to sell these programs for our heating season. The influence of price setting functions on the unregulated and under regulated markets continues to grow as trading on over-the-counter and foreign based exchanges continues to become the norm. American consumers are forced to ride the same rollercoaster ride as energy traders. Because the Commodities Futures Modernization Act created a new breed of markets, the ECM's and deregulated over-the-counter markets, as a whole, this rollercoaster has become more and more unstable, and the volumes of products controlled by one market player alone can determine the price direction of this ride.

The consumer pays for this price immediately. These markets are the price discovery point for all of these commodities and it is immediate. In my own company, as often as four times per day.

In a letter to Congress early this month, the Energy Market Oversight Coalition, which represents over 70 national, regional, and state consumer and trade groups, including NEFI and PMAA, said that in recent allegations against Amaranth Advisors, LLC and other large hedge funds, have put to rest the notion that the market is too big or too complex to be manipulated.

The letter pointed a broad array of actions that Congress can take in order to strengthen the Commission and aid to its enforcement efforts to create a more stable trading environment. In addition to reiterating the need for reform, as it calls for in the letter, we specifically urge the Commission to, one, revisit the use of no action letters to reevaluate the need to withdraw from existing no action letters held by foreign trade boards to perform price discovery functions for U.S. Destined products, ensure that the current and future regulations of ECM's is sufficient to regulate trades of all energy commodities essential to the health and welfare of American citizens and the American economy, and three, include as its advisory committee interest and perspectives not currently represented, including those of small business consumers, energy distributors, storage companies, and noteworthy academics.

Thank you again, Mr. Chairman, and to your colleagues for this opportunity to share my insights on this issue, and I'm open to any questions you may have.

CHAIRMAN LUKKEN: Thank you very much, we appreciate it. We'll turn to Commissioner Chilton for any questions of the panel.

COMMISSIONER CHILTON: Mr. Zerzan, thank you for your excellent testimony. You guys are sort of the poster child for potential unintended consequences, and we're all interested in making sure that we don't do something and overstep. Could you sort of highlight these again for us and give me, you know, why would it be a poor thing, in your judgement, to do what I've sort of been asking other panels, simply get rid of the 2(h)(3) and then allow regulatory flexibility for bilaterals?

MR. ZERZAN: Thank you, Commissioner. I think, in approaching that question, it is important to consider what would be the effect if

2(h)(3) had not been enacted in the first place. I think, for starters, we, you know, ICE is a multi billion dollar American company, it employs Americans and contributes revenue to the United States, and in the absence of 2(h)(3), I really don't think ICE would exist, it certainly wouldn't exist in the United States.

So I think there's a very real concern about what the effect, both from a competitiveness standpoint in terms of the United States as an attractive place to do business, and then there's also a question of, you know, do these markets serve a useful function. Well, clearly they do, because they wouldn't exist if there wasn't a demand for, you know, the ability to do transactions off exchange that you couldn't otherwise do on NYMEX or another market.

And so we understand there's both the utility to 2(h)(3) markets, and there's a social benefit to 2(h)(3) markets in terms of the contribution to the United States economy.

So given that we know the benefit, then

the question is, well, how can we assess what would be an appropriate means of looking at the regulation of a 2(h)(3) market, and it is clearly not an easy position in which you find yourselves, because you know, yes, there's a benefit, and on the other hand we have a constituency that comes forward and says, you know, we don't like what's happening to us, we see these prices, we're getting manipulated, we're paying too much. And that's really why our recommendation is simple. We think to the extent that you can identify a market failure, then by all means, find the least costly way to remedy that.

The difficulty that we, the industry, have is that we have not seen conclusive evidence of a market failure. We see a lot of anecdotal evidence, and certainly, you know, market users represents both, you know, people on the buy side and the sell side, right, we have a lot of venues.

So we don't want people manipulate any markets, the hedge funds don't want people manipulating markets, no one does. But what we really need to consider is, do we have a conclusive case, and if we do, then what's the appropriate way to remedy that.

COMMISSIONER CHILTON: Thanks. Mr. Cooper, do you have any comments about what Mr. Zerzan just said?

MR. COOPER: Well, for every job created by ICE, you've probably lost an industrial job, that was the point of the Huntsman Chemical statement. So, you know, there are costs and benefits, we've got these jobs, we've got these instruments, show me the benefit beyond sheer quantity of trading, but that's what he cited, this incredible increase in the quantity of trading. If you look at your own statistics, if you look at the physical commodities, non-financial commodities, the growth of trading, the growth of open positions, between 1998 and 2005, for agricultural commodities, for medals, it increased by 50 to maybe 100 percent.

These are on exchange credit trade, not over-the-counter. The energies increased by 450 percent. The immense growth of trading in one commodity whose physical consumption and production has barely budged. So the answer is here, hey, as long as it is traded, it must be good.

We ask people, exactly what good is it doing us, and no one could put a finger on it. He hasn't told me it drove the price down, he hasn't demonstrated that it allocated the resource more efficiently. You've heard testimony that it has raised the price.

Those transactions cost money, you know that, transactions are not free. Volatility makes it harder to get physical people to release their commodities. Risk adds to price, transaction adds to cost, so there are costs associated with simply counting the number of transactions, which is what he's told you the benefit is.

We don't see the benefit, we see people who've looked up there and said, hey, there's a speculative premium of $20 a barrel and $3 at MCF. There's a cost associated with that. American consumers are paying, have paid over the last five or six years, $300 billion more for natural gas than they did above what is seen as the physical cost of the commodity. So if you're going to measure cost and benefits, you can't stop at this count of transactions. You have to show me how those transactions actually improve efficiency.

You can't just count the jobs he says he's created, you have to count the jobs the chemical industry says it has lost, because the volatility and price of natural gas in the U.S. has gotten to be much higher than elsewhere and that's where they locate their plant.

They don't want to go, they prefer to use the American laymen, it is much more productive. But when the cost of their physical inputs become so high, that's when you lose jobs. So do the cost benefit analysis. We think there's a demonstration of harm.

And the real answer to your question which has been ducked constantly here is, what is the cost of registering and reporting, that's all we've asked for, register and report. Honest people will be glad to. The bad guys will disappear. What is the cost of that simple act which has a tremendous disciplining force? They keep ducking it, they say, hey, just count the benefits. There's very little cost, you're right, Commissioner Chilton, there's very little cost to what you're asking them to do.

COMMISSIONER CHILTON: Is the clock not working? Because I don't want to --

CHAIRMAN LUKKEN: No, go ahead.

COMMISSIONER CHILTON: I wanted to give Mr. Zerzan a chance to reply just briefly. I don't want to continue to do a counterpoint here, but he said a lot there, so --

MR. ZERZAN: Well, thank you, Commissioner. Actually, yeah, you know, Mark Cooper and I agree, we need to do a cost benefit analysis. I think that we often times hear claims that the consumer is paying 300 times more for natural gas than they should. Frankly, I think those claims strain -- to the extent they don't, to the extent that those are, in fact, accurate figures, then by all means, we would need to do something.

The point is, and this is what the Europeans are doing and this is what our competitors are doing in terms of financial regulation, they are taking a comprehensive, thorough look at the market, and they're doing a cost benefit analysis. And I know that's what the Commission does, and I'm very happy to know that you will continue to do that.

COMMISSIONER CHILTON: Thanks, Mr. Chairman.

CHAIRMAN LUKKEN: Thank you. Commissioner Sommers? Commissioner Dunn?

COMMISSIONER DUNN: I'm not piling on, but I really am. Greg, we heard on the last panel representative from the Huntsman Company and representative from American Public Gas Association explicitly said they have lost confidence in the futures market. And I think I've heard Mr. Cota say the same thing on this panel, and certainly Mr. Cooper is saying that there's loss of confidence. Do you consider that a market failure?

MR. ZERZAN: Well, a market failure is, by definition, an indication that the normal force of supply and demand are not working and prices are reflecting some other, what we might classify as illegitimate factors. When you look at the last several years, in the volatility in the natural gas markets, we can all see, in fact, there were a lot of rather significant events.

There were wars going on in energy sensitive regions, there were hurricanes, there were a lot of isogenous factors at play that could have, in fact, effected supply and demand. And the conclusion I think of the Amaranth report was interesting. What was most interesting was the minority review, from my perspective, in which they said -- and it is clear that different conclusions can be drawn from the same set of facts.

And when you look at the volatility

we've experienced in the natural gas market, there is no question that that would be something that some end users wouldn't want to have to deal with anymore, and they would say, all right, we're going to pull out of these markets because we don't know where prices are going. But that is certainly not, in and of itself, proof that there is something going on in the market other than the natural force of supply and demand, and it shouldn't be treated as such.

COMMISSIONER DUNN: Certainly for those individuals that used to be legitimate hedgers, they're afraid to get into that market place; do they consider that a market failure then from their point of view?

MR. ZERZAN: Well, I think that any time you have a loss of peoples ability to go to the market, that is unfortunate.

If you look at the growth of the markets themselves, as John Damgard said in the previous panel, actually what you see is tremendous increase in the number of people coming to the market.

So you are, in fact, going to find people who will look at the volatility and say, we don't want to participate in those markets. But again, that is not proof of a market failure.

COMMISSIONER DUNN: I think what we determined is, we have an increase of open contracts in the market place. There may be those that say, well, that's because Mr. Gaines' clients are the ones that are in there, not necessarily those that are hedgers are in there. What about Enron, would you consider that a market failure?

MR. ZERZAN: Well, I think -- actually, if you look at the excellent work that the Commission did, in their report market growth, trader participation, and pricing and energy futures markets, a nice way to address the question of what happens when you have all these new non-traditional market participants, and in fact, what happens is, you have increased efficiencies and increased price discovery.

So again, I mean this has been said by

others, but we have this old recurring theme in these price discovery markets. On the one hand, you have end users that say we don't like what's happening; on the other hand, you have, you know, financial market participants and others who are saying, you know, we're sorry, but we didn't cause the volatility, we got in because the volatility was attractive.

And that's why a cost benefit analysis is really the appropriate way to determine this. By all means, if we find people who are doing unsworn things, every single person in the industry on both sides will say, by all means, stop that. But the case has not been made that we're conclusively finding some area where the law is lacking, and until that happens, we're reluctant to say, well, let's make change for change sake.

COMMISSIONER DUNN: You're saying in your testimony that while there is no shortage of people who will attempt to gain the system for their own benefit, the number of people who have successfully done so approaches nil; could that be a possibility because we're not seeing the entire market place, if we're not seeing the information from over-the-counter markets? Do you couple that with the loss of personnel at the CFTC, and the lack of new IT equipment to give us that information?

MR. ZERZAN: Commissioner, as -- was proud to testify before Congress and it will testify again, we believe that CFTC needs increased funding and we will support that whole heartedly to up the staffing in the IT budget.

Having said that, you know, I don't envy the position that you all find yourselves in, because you have two different groups of people saying two very different things. But I think the research that the Commission itself has done points to the conclusion that certainly I've drawn here today, which is that, yeah, the markets are volatile, but we don't have proof that there's this concerted effort to manipulate prices and otherwise effect people in a way that is not subject to the normal rules of supply and demand.

And until we find that, I actually think we set out the possibility to give people false hope. If we say, well, we're going to solve your problem by passing this new regulatory regime, you won't actually solve the problem of volatility, you won't solve the problem that some people are not going to want to get into volatile markets, all you're going to do is make it more attractive for people to operate in other markets. And the reality of it is, tomorrow people can set up a contract or an exchange on the Aisle of Man, the traded contract that settled on the NYMEX crude price, and there would be a lot of people doing business there, and the Commission, you know, obviously wouldn't have any means to access that information. So I think we're actually better off to the extent we can create a regime which I think we probably have in the United States, where we encourage people to do business here, but we still have the enforcement mechanism that the Commission has rather successfully exercised.

COMMISSIONER DUNN: How am I doing on time? I'll get the --

CHAIRMAN LUKKEN: Well, let me ask a question and then we can go back. I was interested in the last point, talking about global competitiveness. I've been, as many of you know, fascinated by Thomas Freedman's "the world is flat concept", that in an electronic digital age, especially in our world, you can locate just about anywhere in the world and conduct business where the cost of doing business might be the lowest.

And so I worry, and this gets to some of the -- this phrase is used too much, but unintended consequences that people talk about. And I want to talk a little bit to Mr. Cooper and Mr. Zerzan about this issue, especially as it relates to energy. Are these the type of commodities that are, by definition, a regional commodity. So we don't have to necessarily worry that if we do something the market doesn't like, that they may move elsewhere? Or are these like some of these other commodities that we see, oil, obviously related to natural gas, where 35 percent of that market share and the WTI now is located in London? How should we approach this? Is it more the former or the latter? And I'd be interested in both of your views on that.

MR. COOPER: Well, natural gas is not nearly as -- as is oil. And so by and large, almost all the natural gas consumed in America is produced in America or in Mexico and Canada. Almost none of it comes from outside of North America. So it is a tied physical commodity.

The hypothesis that people will go to the Aisle of Man, trade over there, do what they want over there, without the ability to also trade here, and remember, that's what I'm telling you, that this government has the power to make people who want to do business in America behave according to our rules with a physical commodity such as natural gas, so I'm not concerned about that.

Second point, and it is -- Mr. Zerzan makes the point that most efforts to gain the market fail. The problem is that, as a physical consumer, while the game is afoot, I may pay a terrible price, and that's what the Senate committee found, that is, yeah, Amaranth in the end went belly up. But for a significant period of time, they effected the price. And as you heard from the previous panel, there are consumers who are physical commodity consumers, they can't walk away from the table when the financial guys say, okay, you're out of luck, because the lights go out. You can't sit and be cold in the dark. So the consumers pay the price for the game, whether or not the people trying to manipulate the market succeed.

Second point, it is not manipulators, it is an institutional structure that creates volatility, that pumps too much money into this market, and transacts and transacts and transacts. In the end, it is a BPU of methane coming out of the ground over here and a BPU of methane going into my burner. And all of those transactions in between have a cost.

And so, frankly, if you cause people to register and report, and reduce the number of transactions by one-half, you would still have plenty liquidity and less volatility, less risk, less transaction cost. So the game itself, and it is not manipulation, that's why -- you need to look at more than manipulation.

One final point, because people have asked this question about double jurisdiction and the FERC. When an agency fails to do its job, and there is a perception among we end users that the commodity markets have been failing us, the reaction of the federal government is, in fact, to get another agency to try and help it do its job. I understand that rubs a little bit raw in this agency. But the idea of the FERC being given new powers to oversee these markets, they were supposed to go beyond what the CFTC does, they were supposed to, in my opinion, look past manipulation, which is what you specialize in, and look to influence.

Now, they didn't choose to exercise that authority. But I'm telling you that if we continue down this road, you're going to get more and more agencies who are told to do your job. It is not multiple jurisdiction, it is that there are other problems here beyond manipulation that need to be addressed.

MR. ZERZAN: Well, your question I think was, you know, how can we treat the commodity itself, and to the extent you have a functioning futures market, as we have in the United States, and they're very healthy liquid markets, you can take that price and settle your over-the-counter contract on that settlement price. So as long as you don't actually care about, you know, delivering at Henry Hub, you are, in fact, free to operate anywhere in the world, and that is, in fact, what we increasingly see.

MR. COTA: Mr. Chairman, if I could comment on that, as well?

CHAIRMAN LUKKEN: Sure.

MR. COTA: With regard to U.S. testing energy products, and that's where we've kind of drawn the line, the U.S. market is such a large energy consuming market that, regardless of whether the trading is occurring in the Aisle of Man or in Moscow or wherever it wants to be, there's enough trading here that's going to occur because the physical trades are here and because these are physical markets.

And the speculators will go to wherever the play in the market is that they can play it all the way out in the safe market. So I think that you will continue to see exchanges, whether they be underseen by you or wherever, as long as it is U.S. Destined products, they're going to continue to be here.

The amount of trading is huge. The heating oil market is about eight billion gallons annually in the United States. That trade is about two or three times a day. So the volumes of trades and the amount of liquidity is very significant. The measure of liquidity, according to NYMEX when we met with them a number of years ago, was measuring the options prices, and that was the first indicator of volatility and how much money was moving in and out of the market.

I used to be able to hedge for my consumer base on options -- I had the money option for putting the call for between four and six cents about four years ago. Well, that same deal this summer, to do a winter hedge, was between 50 and 60 cents per gallon. So that's a huge increase in volatility. And the reaction from people in the market, companies like myself, is that with that increase volatility and that risk, that that's causing a greater reluctance to participate in the markets in order to hedge, and we need speculators. Speculators are key. But if almost all of the transactions are purely speculation transactions and none ever seem to get into a physical market, people who are in the physical market will then migrate out of those markets. And we think these markets are very important for the consumers.

That's not going to effect the pricing. If government thinks that if you guys are brilliant, the price is going to go down, that's unrelated to this. But lowering the volatility will create more stability in the markets, and in my opinion, make these markets more secure in the future.

CHAIRMAN LUKKEN: All right. Thank you very much. Commissioner Chilton.

COMMISSIONER CHILTON: Just one final one. Mr. Zerzan, you mentioned the -- a couple of times that this issue is being debated and considered in other countries, and one, I'd like to know a little bit more about that, but two, is that because of Amaranth and the PSI hearing and things that have gone on in this country? Are they so worried about what's going on here in our markets that now they're looking at themselves? And if that's the case, what exactly are they doing? You talked about it a couple of times.

MR. ZERZAN: Thank you, Commissioner. What we find in most of other jurisdictions in which we operate is that there's a unitary regime for financial instruments, derivatives being a part of that unitary regime. And then the application of different parts of the overall structure which would apply to derivatives are carved out.

So, for instance, in the European Union, we have the markets in financial instruments directive, and commodity derivatives are separately carved out and excluded from the law, subject to a review that's happening right now as to what exactly an appropriate regime might be.

Separately from that, eligible counter party contracts are carved out, which is not, you know, remarkably different from what we have here in the United States.

With regards to your second question, I have found, particularly in Europe, there is conversation about Amaranth, there is conversation often times about some of the other nation states that are not part of the European Union, but take your concerns, and so the same debate goes on there.

And that's why actually I think the

McCreevy formula, the federal regulation formula is so useful, because as our counterparts in Europe approach this same public policy question, how do you balance liquidity and transparency, how do you promote free markets, but also make sure that people are getting proper prices, they encounter it through that two-step process, has there been a market failure, and if so, what is the least burdensome means of addressing it. And so as we go forward in this debate, I think that's a very useful strategy to keep in mind.

COMMISSIONER CHILTON: Thanks; thanks, Mr. Chairman.

CHAIRMAN LUKKEN: Any further questions? Commissioner Dunn.

COMMISSIONER DUNN: Mr. Gaine, you've been quiet here, so we have to give you an opportunity, and it won't be too tough.

But I've often heard it said that the managed funds do provide a role at providing liquidity in the market place on both sides; could you amplify on that a little bit?

MR. GAINE: Well, I think all the data that's available would support that notion. In fact, even in Amaranth, I believe there are published reports that Amaranth obviously was the hedge hunt on one side, that there were hedge hunts on the other side of that trade.

And Mr. Cota is talking about a spread in his options where, if you didn't have liquidity in there, that spread would be wider, my guess would be. I think it is grown enormously. I mean the alternative investment, which covers a whole host of areas, but includes on exchange features and over-the-counter swaps and other derivatives, the growth has been, from ten years ago, approximately $50 or $60 billion to something 1.67 trillion, I think is the story I'm going with today. It is a huge, you know, a huge growth. A lot of that would be on your designated contract markets, as well as ECM's. And I don't think there's any doubt that the liquidity of our managed futures programs, as well as the hedge funds is an enormous factor in virtually all of these markets.

It is a fact very well recognized I think in the President's Working Group reports of you and the treasury, the fed, and the SEC, and I don't, you know, we're, as Mr. Zerzan suggested, hedge hunts have no interest in market instability.

I think volatility possibly to some of our members is okay, if the price is moving up and down, but there are hurricanes, as he pointed out, and there is a war in the Middle East, a 450 percent increase in petroleum under those circumstances, far be it for me, just a lawyer, to judge whether that's too high or too little. I know your wheat and corn people are pretty happy lately.

You know, picking prices has never been my specialty, nor has it been an interest of this Commission. And I think sometimes these debates evolve into this. I remember we were up before the Senate Judiciary Committee on short selling, abusive short selling of equities, and that week hedge funds were responsible for lowering equity prices and raising energy prices.

We were kind of like magicians. And I don't think -- and recently the FCC has taken a number of steps to relax or ease the ability of hedge funds to access short selling positions, and that's as a result of enormous economic research and study over the years by the exchanges, as well as the SEC. Liquidity of "the speculator" is invaluable to just about any market place.

COMMISSIONER DUNN: Mr. Cooper, I've got one final question. I direct it to you, you've talked about registration and reporting. Most of the cases, fraud cases that we have brought, the energy has been based upon false reporting; do you see that as a problem in the energy sector?

MR. COOPER: Well, that certainly was a problem over at the FERC and with natural gas. Clearly, the private reporting services had a severe problem with people misreporting. Those numbers were published and people executed transactions on the basis of falsely reported numbers, selectively reported numbers. And it is fascinating that the moment the FERC suggested that they wanted honesty in reporting, the volume of reporting collapsed and never recovered.

That is, people stopped reporting because they were afraid that someone might actually check up on whether or not they were lying, and that's the mistake of not requiring reporting. And now the FERC is in court with private agencies to get access to the reports. I mean they're claiming -- so the point is that reporting is extremely important. One of the things that we recommended in the report for the Attorneys General, again, looking at the end user, and we actually do care about the price, I understand that the traders really don't care what the price is, but we actually pay the price, we write the check.

One of the recommendations we talked about was preventing utilities from indexing their prices to any unregulated report. It would be an interesting, disciplining force. It'll put those private agencies out of business in a minute.

But the simple fact of the matter is that the person who buys my natural gas is a regulated entity who's is extremely risk adverse, and my mother and grandmother actually think that's a good idea, and so, we start looking at ways to drive back from the consumer side to get honesty in the process, and that was one of the recommendations, was to maybe tell the states to stop letting them use any unregulated index as a reference price in their contract. Thank you.

CHAIRMAN LUKKEN: Thank you very much. Well, I have no further questions. So on behalf of my Commission colleagues, I just want to thank this panel and all panelists today for the very informative and varied testimony that we received. All this information is going to be very useful as we go forward in trying to advance this issue. I also want to thank all the audience who stuck around all day, including some friends from the Hill. I know it is been a long day, but we appreciate your attendance, and hopefully we'll continue to work with you down the line.

Before we adjourn, I'd like to remind everyone that a transcript of the hearing will be made and entered into the Commission's public comment record, which will remain open for receipt of written comments until next Monday, September 24th.

Also, I want to remind folks that our next Commission meeting will be on October 2nd, the Global Markets Advisory Committee. Charlie McCreevy was mentioned here today. We have colleagues from the EU coming over to talk about these issues that are going on in the European Union, in the Commission, and also MFID and European Clearing Code of Conduct and other issues relating to commodities. So it should be an interesting debate, and I wanted to inform you of that. But if there's nothing further, the meeting is -- oh, Commissioner Dunn.

COMMISSIONER DUNN: Mr. Chairman, I would like to thank the staff for putting the meeting together as well if all of us were participants, but most importantly, I'd like to thank you. You made a commitment at the PSI hearing, you have followed through on it, and you're a man of your word. Thank you.

COMMISSIONER CHILTON: Ditto.

CHAIRMAN LUKKEN: Well, I wouldn't want to let the meeting adjourn before thanking staff, as well, because they did most of the heavy lifting here today, and we're so lucky to have such valued staff here at the CFTC. So with that, the meeting is adjourned.

(Whereupon, at 3:17 p.m., the PROCEEDINGS were adjourned.)

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