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Commodity exchange regulators ask Congress for more authority over electronic exchanges

BYLINE: By DAN CATERINICCHIA, AP Business Writer

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Federal commodity regulators on Wednesday asked Congress to give them greater oversight of electronic exchanges as a way to deter potential price distortion and manipulation, and to protect consumers.

A congressional investigation earlier this year found a hedge fund that collapsed after losing more than $6 billion in natural gas trades had shifted its activities to an unregulated electronic exchange to avoid trading limits, and that this "excessive speculation" drove up homeowners' heating bills.

In a report to Congress on Wednesday, the Commodity Futures Trading Commission asked for enhanced authority over unregulated electronic exchanges, such as the InterContinental Exchange Inc.

The commission seeks mandated trading reports, position limits and self-regulatory rules comparable to those that apply to contracts traded on regulated exchanges, such as the New York Mercantile Exchange Inc.

Natural gas trades on both exchanges influence prices on the other, but only the Nymex has been fully regulated thus far, and the commission needs greater authority "to detect and prevent manipulation in these markets," acting CFTC Chairman Walter Lukken told the House subcommittee on general farm commodities and risk management.

The commission also is seeking emergency authority to prevent manipulation and disruptions of the cash-settlement process.

Congress is currently considering reauthorization of the Commodity Exchange Act, which governs the commission's role. The CFTC recommended amending the act to increase the penalties available for certain violations, such as manipulation and false reporting, to $1 million and 10 years in prison.

The commission also needs heightened authority to police retail fraud, especially in foreign currency trading, Lukken said.

Some lawmakers also want energy market trades regulated to protect consumers from further multibillion-dollar collapses like the one that struck hedge fund Amaranth Advisors LLC in September 2006.

Sen. Carl Levin, D-Mich., who chairs the Senate's permanent subcommittee on investigations, welcomed the commission's report and said all four of its key recommendations are in the bill he introduced last month designed to close the so-called "Enron loophole" that allows electronic energy exchanges to operate outside federal regulation. Rep. Bart Stupak, D-Mich., has authored similar legislation in the House.

An investigation by Levin's subcommittee earlier this year found that Amaranth shifted its activities to ICE to avoid the Nymex's trading limits.

"The CFTC's support will advance the prospects for getting a bill passed this Congress," Levin said. Nymex officials also endorsed the commission's report.

ICE is largely supportive of the commission's recommendations, but company spokeswoman Sarah Stashak on Wednesday said discussions need to continue to determine if the proposed rules would apply to futures-like products or all products on the market.

Jeffrey Sprecher, chairman and chief executive of the ICE, last month told the commission that some heightened government scrutiny may be appropriate but that a "one size fits all" approach would be misguided.

But the commission appears focused on the large energy futures contracts. The report said its "current level of regulation is appropriate" for exempt contracts "when trading volume remains low and their prices are not significantly relied upon by other markets."

The commission also said it intends to establish an energy markets advisory committee to conduct public meetings on relevant issues and to work with the Federal Energy Regulatory Commission to develop best practices for utilities and others who use Nymex settlement prices as hedging vehicles and benchmarks in pricing their energy products.

Shares of Atlanta-based ICE added $1.47 to $170 in afternoon trading, while Nymex rose $2.03 to $128.77.

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CURRENT NEWS

CFTC Says Reach Would Extend To More Natural-Gas Contracts





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By Siobhan Hughes
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WASHINGTON (Dow Jones)--The Commodity Futures Trading Commission's top regulator for the first time called for new powers to oversee unregulated markets, and said that the agency's approach would for now extend its reach mainly to a popular natural-gas contract.

"That's where the focus is right now, on natural gas," the acting CFTC chairman, Walt Lukken, told reporters after testifying on Capitol Hill.

Federal regulators are asking Congress for the powers one year after the meltdown of hedge-fund Amaranth Advisors LLC put a spotlight on the role played by markets in affecting energy prices. The CFTC has said that it wasn't aware of the hedge fund's trading in unregulated natural-gas markets. Some big buyers, such as utilities, believe that the gap in oversight permitted Amaranth to game the system in ways that boosted prices just as they were locking in their costs.

Under the CFTC's proposal - which would need to be put into law by Congress - the agency would be able to require reporting of large bets on futures contracts traded on unregulated, electronic markets. The CFTC would also be able to require the market to set limits on the size of the trade that may be placed, among other authorities. The powers would come into play only for contracts that are broadly used - or "referenced" - for the purposes of determining prices.

The CFTC's call may give new impetus to a bill introduced by Sen. Carl Levin, a Michigan Democrat, that would give the agency new powers over unregulated energy-trading markets. Levin has said that he may try to attach the measure to a farm bill. It isn't clear when that bill will reach the Senate floor.

"The CFTC's support will advance the prospects for getting a bill passed this Congress," Levin said in a statement, "and stop trading abuses that distort U.S. energy prices."

Some of the biggest names in energy trading had encouraged the CFTC to take a limited approach, rather than bringing a host of new futures contracts under government oversight. At a CFTC hearing convened in September, Jeffrey Sprecher, the chairman of InterContinental Exchange Inc. (ICE), whose main business is largely unregulated, warned about eliminating exemptions for contracts besides its natural-gas contract.

Some House lawmakers remained on guard.

"I think we need to do a little bit more work on this to fully understand whether or not the changes that have been proposed will have the effect of calming the oscillations that we've seen as a result in part of major speculation in energy markets," said Rep. Jim Marshall, a Georgia Democrat, at a hearing in a House Agriculture Committee subcommittee.

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CFTC signals radical change to OTC markets

By Jeremy Grant in New York

Financial Times
Updated: 4:11 p.m. ET Oct 24, 2007

US watchdogs on Wednesday signalled sweeping change to the way the vast over-the-counter commodity and energy derivatives markets are overseen when they unveiled proposals that would tighten regulation of trading on OTC electronic trading platforms.

The move, by the Commodity Futures Trading Commission, could fuel questions about the risk of driving OTC trading from the US to London.

It affects so-called "exempt commercial markets", such as the Intercontinental Exchange (ICE) and other venues, and is the culmination of months of pressure from some lawmakers to bring ECMs in line with the way traditional futures exchanges - such as the New York Mercantile Exchange - are regulated.

It also came as the Government Accountability Office released a report on Wednesday raising questions about the CFTC's oversight at a time when increasing amounts of energy derivatives trading occur on markets that are "largely exempt from CFTC oversight".

ECMs were exempted from full CFTC surveillance under a 2000 law that presumed participants in OTC markets were largely able to self-police their activities. It came as OTC trading was taking off at Enron, the now-defunct energy group.

But controversy over the way hedge fund Amaranth last year chalked up about $6bn in losses trading on Nymex and ICE prompted calls for a narrowing of the gap between CFTC-regulated exchanges and the ECMs.

Senator Carl Levin has drafted legislation that would close the gap - which he calls the "Enron loophole". He has said lack of sufficient oversight over ICE allowed Amaranth traders to build up huge positions in natural gas contracts at will, resulting in "excessive speculation" that hurt consumers.

Walt Lukken, acting CFTC chairman, told a congressional hearing that the CFTC now recommended legislative changes for ECM contracts that would "serve a significant price discovery function". The move marks a shift for the regulator, which had long said it had all the tools necessary to police the markets.

The CFTC proposed that Congress give it the power to implement a system of "large trader reporting", by which ECMs would be required to provide the

CFTC with the same kind of reports of large trades that exchanges such as Nymex already are required to do.

The system would "enable the [CFTC]'s market surveillance staff to monitor positions on a daily basis to detect and deter possible manipulative schemes".

An ECM would also be required to adopt "position limits" or "accountability levels" already in place at futures exchanges. They are designed to warn an exchange of over-concentration by a trader in one contract.

An ECM should also be required to "monitor trading of a listed contract that serves a significant price discovery function".

Mr Lukken said the recommendations were designed to "strike a delicate balance between the appropriate level of market oversight and transparency while promoting market innovation and competition to ensure that these markets remain on US soil."

Paul Architzel, counsel specialising in futures regulation at law firm Alston & Bird, said that while there was always a risk that tighter regulation might drive business offshore, there was less likelihood of this happening since OTC energy and commodity derivatives were involved.

"With an electronic [market] infrastructure it's much easier to move business offshore but straight financial futures are more portable than commodity products. That's because they can involve delivery of the underlying commodity, which makes it more of a localized trading vehicle," he said.

In its report, the GAO recommended that Congress "further explore whether the current regulatory structure for energy derivatives, in particular for those traded in exempt commercial markets, adequately provides for fair trading and accurate pricing of energy commodities".

It suggested that this be done as part of the process of re-authorisation of the CFTC, which was the subject of Wednesday's hearing. Re-authorisation is a process by which Congress re-examines a federal government agency's statutes and budget, and can result in changes to an agency's powers. Re-authorisation of the CFTC is about two years overdue.

ICE welcomed the CFTC's proposals. Jeffrey Sprecher, chief executive, said it provided "regulatory certainty for the oversight of OTC markets".

"The spirit of their recommendations is largely consistent with the views we have expressed in several testimonies this year. Such a solution recognizes and addresses the complexities of OTC markets and preserves the significant economic and utility benefits of a properly functioning market.

He pointed out that ICE a year adopted "daily position reporting" for its main OTC markets.

"The concept of position accountability and 'self-regulatory-like' authority would provide ICE with the ability to take action in its markets if necessary. We will continue to engage in a dialogue with regulators, the industry and Congress, and look forward to effectively resolving this long-standing matter," Mr Sprecher said.

Commenting on the proposals, Sen Levin said: "The CFTC report is a very positive development. The CFTC acknowledges the vulnerability of US energy markets to price manipulation and excessive speculation, calls for tougher market oversight, and recommends legislative changes to put a cop on the beat in all US energy markets. All four of the CFTC's key recommendations - large trader reporting, position limits or accountability levels, self-regulatory oversight, and emergency authority to require traders to reduce positions - are already in the Close the Enron Loophole Act I've introduced. The CFTC's support will advance the prospects for getting a bill passed this Congress to close the Enron loophole and stop trading abuses that distort U.S. energy prices."

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CURRENT NEWS

CFTC Proposes Congress Increase Agency's Regulation of Certain Contracts



Daily Report for Executives

The Bureau of National Affairs, Inc.
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Futures Trading

CFTC Proposes Congress IncreaseAgency's Regulation of Certain Contracts

The Commodity Futures Trading Commission is recommending to Congress that the agency be authorized to collect large trader data on some contracts exchanged on markets currently exempted from all but the lightest of oversight as part of an effort to task those markets with stricter regulatory expectations.

In a report delivered to the House Agriculture Committee Oct. 24 and in testimony by the CFTC's acting Chairman Walter Lukken that day before the committee's General Farm Commodities and Risk Management Subcommittee, the agency also urged Congress to require exempt commercial markets to adopt self-regulatory functions, accountability levels for certain contracts, and to be given, along with the CFTC, emergency authority to "alter or supplement rules."

The subcommittee hearing was the second in recent weeks on the subject of Commodity Exchange Act reauthorization. The act expired in 2005, but has been kept on the books through continuing resolutions.

At the hearing, Lukken also urged Congress to close a loophole that has hindered the CFTC's ability to pursue suspected scams involving futures and options on foreign currency, as well as to clarify that the commission has the authority to bring actions involving off-exchange "principal-to-principal" futures transactions.

2000 Rules.

The ability of the CFTC to oversee contracts on otherwise exempt commercial markets [ECMs] has been the topic of hearings and legislation for months. In 2000, during the last CEA reauthorization, Congress deregulated the futures industry to the point that exchanges could register for different levels of oversight. Designated contract markets [DCMs], on which anyone can trade and where contracts are thought to have a significant price discovery function that affects consumers, are fully regulated.

At the same time, ECMs were conceived as exchanges where only sophisticated institutional investors would participate, trading contracts that would have no bearing on consumer prices. In the last year, however, a consensus has emerged that in at least one natural gas contract on the InterContinental Exchange, an ECM, trading mirrors trading of the same commodity on the New York Mercantile Exchange, a DCM. Observers say this means that the ICE contract is fulfilling a price discovery function and therefore should be regulated.

Lukken suggested that criteria be established to determine whether an ECM contract mirrors a DCM contract. Specifically, he said, such criteria should include a contract's liquidity/trading volume as well as its "linkage" to a regulated contract.

Volume "must be significant enough to affect regulated markets or to become a pricing benchmark," according to the CFTC's report. For linkage, "the relevant ECM contract must either be influencing other markets and transactions ... or be materially referenced by others in interstate commerce on a frequent and recurring basis."

Evolving Regulation.

In testimony to the committee, Lukken remarked that "energy markets have changed dramatically" since the 2000 reauthorization, and that "the commission's regulation of these markets should evolve in kind." He stipulated also that certain energy contracts on ECMs—specifically, natural gas contracts on ICE—"now function as virtual substitutes for contracts listed on regulated exchanges, with tight correlation and linking of prices and participants." Lukken added later that "[n]ot only are the products substantially identical in terms and pricing, but the market participants are also the same."

The acting chairman cited data that the top 25 natural gas traders on Nymex all also "trade significantly" on ICE, arguing accordingly that "changes to the CEA are necessary in order for the commission to detect and prevent manipulation in [ECMs]."

Agriculture Committee Chairman Collin Peterson (D-Minn.) said in a statement that to the nonexpert, "it would appear that there are separate markets out there that appear to be similar, but [that] are playing under different rules." At the same time, however, Lukken summoned the spirit behind the deregulation of 2000 when he urged that "any legislative changes should not result in stifling the innovation and other benefits brought about by ECMs."

Futures trading has exploded since 2000, when approximately 500 million contracts were traded. So far this year, volume on domestic exchanges has topped 3 billion, according to the CFTC; both regulators and industry participants attribute the spike almost solely to changes made in 2000, which they say encouraged entrepreneurship and competition. Lukken said he was confident that the CFTC's proposal "strikes the right balance of ensuring that these markets remain free of manipulative conduct while allowing the markets to grow and innovate on U.S. soil."

Zelener Clarification.

On another matter, Lukken reiterated past testimony from other CFTC officials that his agency's enforcement mandate was hindered by a court decision in CFTC v. Zelener that off-exchange foreign currency derivative trades were not futures contracts and therefore outside the CFTC's jurisdiction. Lukken told the subcommittee that the decision, which was affirmed on appeal, "provided a roadmap to scam artists" for how to run a successful forex scam.

Lukken asked that Congress "clarify" that the CFTC has authority in such cases. If not, he said, "a large sector of retail fraud will remain effectively outside of the prosecutorial authority of the CFTC."

He forwarded a 2005 proposal by the President's Working Group on Financial Markets that would require those who solicit the public for forex transactions to register with the CFTC and that would close a loophole that allowed firms to act as counterparties in their own forex transactions.

Finally, Lukken asked Congress to clarify that the CFTC has authority over "principal-to-principal" futures transactions. "This clarification is necessary" he said, "to eliminate a potential obstacle to the use of the CFTC's antifraud authority in today's non-intermediated markets." The acting chairman said the clarification was necessary to implement congressional intent from 2000.

Following the hearing, Sen. Carl Levin (D-Mich.), a critic of the oversight regime created by the 2000 reauthorization with respect to ECMs, issued a statement calling the CFTC report and proposal "a very positive development." Levin in September introduced a bill (S. 2058) that would that would subject ECMs to CFTC oversight.

CURRENT NEWS

CFTC Changes Rule to Require Traders To Report Details From Exempt Markets



Daily Report for Executives

The Bureau of National Affairs, Inc.
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Futures Trading

CFTC Changes Rule to Require TradersTo Report Details From Exempt Markets

The Commodity Futures Trading Commission Oct. 22 adopted rule changes that will require parties holding or controlling reportable positions on a regulated market to retain books and records regarding all other positions and transactions in the commodities in which the trader has a position, and to make them available to the commission upon request.

Under the change, traders holding a position on a certain commodity on a regulated market also will have to report positions and transactions in the commodity that occur on over-the-counter markets, foreign boards of trade, and other exempt markets.

Adopted as proposed earlier this year, the amendment to Regulation 18.5 under the Commodity Exchange Act was intended to make the rule "clearer and more complete with respect to hedging activity" (127 DER A-17, 07/3/07). The commission proposed the rule change following the collapse of the Amaranth Advisors LLC hedge fund in 2006, which Sen. Carl Levin (D-Mich.) and others suggest was triggered by off-exchange energy trading leading to "excessive speculation" in the natural gas markets (122 DER A-23, 06/26/07).

Clarifications.

Specifically, the CFTC explained in Oct. 24 release, it amended Regulation 18.05 to clarify:

•that traders holding reportable positions are required to keep information relating to those positions—including information regarding positions and transactions held or executed outside the regulated market; and

•what constitutes hedging activity with respect to a reportable position.

"This clarification will bring added transparency. It also serves as an important complement to the CFTC's report released to Congress today recommending an increase in the oversight of some trading activity on electronic trading facilities know as Exempt Commercial Markets," CFTC Acting Chairman Walt Lukken stated (see related report in this section).

The rule change becomes effective 30 days after Federal Register publication.

Text of the rule change is available at http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr_fedreg102407.pdf. For more information, contact Duane Andresen in the CFTC Division of Market Oversight at 202/ 418-5492.

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Bloomberg.com

CFTC Proposes Expanded Authority Over Exempt Markets (Update5)

By Tina Seeley and Matthew Leising

Oct. 24 (Bloomberg) -- The U.S. Commodity Futures Trading Commission proposed expanding its oversight of certain contracts on electronic exchanges including Intercontinental Exchange Inc.

The commission, in a report to Congress today, recommended increasing oversight of trading activity of contracts that help to set prices on the exchanges, including requiring reporting of large trading positions and establishing limits on the number of contracts an entity can hold.

The recommendations ``strike a delicate balance between the appropriate level of market oversight and transparency while promoting market innovation and competition to ensure that these markets remain on U.S. soil,'' Acting Chairman Walter Lukken said in the release.

The commission has been under Congressional pressure to increase its regulation of Intercontinental, known as ICE, after the collapse last year of hedge fund Amaranth Advisors LLC. Greenwich, Connecticut-based Amaranth moved much of its natural gas trading to ICE after hitting limits on the New York Mercantile Exchange.

``The CFTC is asking for greater oversight of the Intercontinental Exchange as it relates to oil and natural gas in the OTC market,'' Terry Duffy, chairman of CME Group Inc., said in an interview. The commission is seeking more data from ICE to better police energy markets, he said. CME Group was created in July by the combination of the Chicago Mercantile Exchange and Chicago Board of Trade.

Nymex Rules

CFTC's proposed changes would make electronic exchange rules similar to those in place at the New York Mercantile Exchange, which competes with ICE. Nymex has joined calls from Democratic Senators Carl Levin and Dianne Feinstein to bring ICE and other electronic energy exchanges under tighter regulatory oversight, to help make markets more transparent.

The new policy comes a month after the commission held a hearing about the issue, at which Jeffrey Sprecher, chief executive officer of Atlanta-based ICE, told regulators they have the authority to oversee certain contracts traded on ICE markets.

Sprecher said his company supports the move by the commission.

``The spirit of their recommendations is largely consistent with the views we have expressed in several testimonies this year,'' Sprecher said in an e-mailed statement. ICE began reporting to the commission daily positions in its ``primary OTC'' markets a year ago, Sprecher said.

Lukken testified today before a House subcommittee on legislation Congress is supposed to approve every five years to reauthorize the commission. He also called for increasing the commission's penalty authority to $1 million.

`Incubators' for Products

Exempt markets serve as ``incubators'' for new market products, the commission said in the report. When a contract ``matures and begins to serve a significant price discovery function'' it ``warrants some increased regulatory oversight,'' the commission said.

``Current regulatory disparities'' between markets such as Nymex and ICE also ``create competitive concerns that may unfairly advantage'' exempt markets including ICE, the commission said.

``We want to make sure that we're seeing the trading that's going on, that there are proper controls in place to prevent manipulation and that if we see manipulation then we have the ability to go after it,'' Lukken told reporters after the hearing.

The requirements, which must be approved by Congress and signed by the president, would be triggered when a contract reaches a certain level of volume and if it is linked in some way to prices on a regulated exchange.

Initially that means ICE's natural-gas contract, linked to a gas market on Nymex, would qualify for additional regulation, Lukken said.

As written, the rules could apply to other contracts traded on exempt markets that eventually help to set prices, including emissions credits, said Lukken.

Feinstein and Levin have introduced separate pieces of legislation that would require closer oversight of the ``exempt commercial markets.''

California's Feinstein says the exemption is a relic of Enron Corp.'s lobbying and has created a loophole for market participants to avoid reporting.

``The CFTC report is a very positive development,'' Levin of Michigan, chairman of the Permanent Subcommittee on Investigations, said in a statement. ``The CFTC's support will advance the prospects for getting a bill passed by this Congress to close the Enron loophole and stop trading abuses that distort U.S. energy prices.''

Levin Legislation

Levin said the CFTC's recommendation supports his legislation, introduced last month after his subcommittee issued a report charging that Amaranth moved its trading to ICE's over- the-counter market after being told by Nymex to reduce its positions.

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