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CRS Report for Congress

CFTC Reauthorization

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Summary

Authorization for the Commodity Futures Trading Commission (CFTC), a "sunset" agency established in 1974, expired on September 30, 2005. In the past, Congress has used the reauthorization process to consider amendments to the Commodity Exchange Act (CEA), which provides the basis for federal regulation of commodity futures trading. The last reauthorization resulted in the enactment of the Commodity Futures Modernization Act of 2000 (CFMA), the most significant amendments to the CEA since the CFTC was created in 1974. Both chambers considered reauthorization bills in the 109th Congress, but none was enacted. The Senate Agriculture Committee approved S. 1566, a CFTC reauthorization bill offered by Chairman Chambliss, on July 21, 2005. The House passed H.R. 4473 by voice vote on December 14, 2005. The 110th Congress is expected to take up reauthorization. This report provides summaries of current reauthorization issues, including (1) regulation of energy derivatives markets, where some blame excessive price volatility on a lack of effective regulation, (2) the legality of futures-like contracts based on foreign currency prices offered to retail investors, and (3) the market in security futures, or futures contracts based on single stocks, which were authorized by the CFMA, but trade in much lower volumes than their proponents expected.

This report will be updated as developments warrant.

Futures contracts — like other financial derivatives such as options or swaps — gain or lose value as the price of some underlying commodity rises or falls. They allow traders to invest in corn, gold, or T-bills without actually owning the underlying commodities themselves. Futures can be used to avoid, or "hedge," price risk. That is, farmers, utilities, airlines, banks, and many other businesses can use derivatives to protect themselves against unfavorable changes in commodity prices, interest rates, or other variables. Most futures trading, however, is done by speculators who profit if their forecasts of price trends are correct. (The futures exchanges are associations of professional speculators.) There are two benefits to speculation: liquidity and price discovery. Speculators provide liquidity because they are willing to assume the risks that hedgers wish to avoid. Speculation provides an efficient price discovery mechanism because futures prices adjust immediately to new information and serve as the basis for many physical (or spot market) transactions in oil, agricultural, and other markets.

The public interest in regulating futures markets flows from these two functions. Because futures prices are used as reference points for many physical transactions, manipulation in the futures markets can affect the prices actually paid by consumers or received by farmers and other producers. Similarly, the ability to hedge risks allows the economy to function more efficiently. Former Federal Reserve Chairman Alan Greenspan frequently described the general benefits of derivatives markets. For example:

> Derivatives have permitted financial risks to be unbundled in ways that have facilitated both their measurement and their management.... Concentrations of risk are more readily identified, and when such concentrations exceed the risk appetites of intermediaries, derivatives can be employed to transfer the underlying risks to other entities. As a result, not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient.[1]

How much government regulation is needed to see that derivatives markets remain sound, to keep markets competitive and free from fraud and manipulation, and to insulate the financial system from shocks arising from sudden large speculative losses? What kinds of customers are in need of government protection? These are the basic questions for congressional oversight of the Commodity Exchange Act (CEA).

The Commodity Futures Modernization Act of 2000 (CFMA)

In several respects, the CFMA was a fundamental rethinking of the government's role in derivatives markets. Before 2000, the CEA was intended to regulate all forms of derivative trading; any contract "in the character of" a futures contract was to be traded only under CFTC regulation. However, this "one-size-fits-all" regulatory scheme did not correspond to the reality of the marketplace, where a very large over-the-counter (OTC, that is, off-exchange) derivatives market was flourishing without CFTC oversight. Under the CFMA, most trading in OTC derivatives was placed beyond the reach of the CEA (and thus the CFTC). Where trading was off-limits to small investors, market discipline was deemed to be a sufficient regulatory force.

The exception was for contracts based on agricultural commodities, which were thought to be susceptible to price manipulation. Agricultural derivatives, as a result, can generally be traded only on CFTC-regulated futures exchanges.

The CFMA provided for the creation of unregulated futures exchanges, where all trading involved sophisticated or professional investors. (Again, there is an exception for farm derivatives.) Potentially, therefore, the futures exchanges can reconfigure themselves into largely unregulated entities, and several such entities have registered with the CFTC. However, since the enactment of the CFMA, the major futures exchanges continue to operate in (more or less) the same regulatory environment as before. Both the

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[1] Remarks by Chairman Alan Greenspan at the 2003 Federal Reserve Bank of Chicago Conference on Bank Structure and Competition, Chicago, Illinois (via satellite), May 8, 2003.

exchanges and the OTC markets have experienced strong growth in trading volumes since 2000.

In the 108th Congress, the House and Senate Agriculture Committees held oversight hearings on the CFMA.[2] At both hearings, CFTC Chairman James Newsome stated his view that the CFMA had worked well and that the CFTC was able to use more flexibility in matters such as approving new contracts for trading and accepting the registration of new exchanges and clearing houses. The new entrants generally sought to introduce or facilitate innovative electronic forms of trading. His view was that legislative amendments to the CEA were not needed.

The Debate in the 109th Congress

Given the CFTC's satisfaction with its role under the CFMA, and the growth of trading volumes and continued innovation in the markets, few in the 109th Congress saw any need for another thorough overhaul of the CEA. Several members of the House Agriculture Committee, in fact, expressed support for a one-line reauthorization bill that made no other amendments to the CEA. During hearings before the House and Senate Agriculture Committees, however, the CFTC and industry participants suggested several areas where fine-tuning of the CFMA might be desirable. Several of these issues are addressed by S. 1566 (the bill approved by the Senate Agriculture Committee on July 21, 2005) and H.R. 4473 (approved by the House Agriculture Committee on December 7, 2005, and passed by the full House on December 14), and are summarized briefly below.

Energy Derivatives

Energy markets have seen turmoil in recent years: prices have been high and unusually volatile, and there have been several episodes of fraud or scandal. During the California electricity crisis of 2000, severe shortages were combined with soaring prices, and several energy trading firms (including Enron) were found to have manipulated the partially deregulated electricity marketing system that California had established. After the collapse of Enron, numerous energy firms were found to have made fictitious "wash" trades, for purposes of manipulating prices and/or falsifying their accounting statements. The CFTC has charged dozens of traders with manipulating the price of natural gas by providing false information about market prices and supplies. Finally, many commercial users of energy commodities suspect that hedge funds and other financial speculators have driven prices higher than fundamental economic factors of supply and demand would warrant, and have called for more CFTC oversight of OTC markets and/or limits on the size of speculative futures positions.

Some observers attribute these problems in the markets to a regulatory gap, arguing that neither the CFTC nor the Federal Energy Regulatory Commission (FERC) has sufficient authority or resources to enforce anti-fraud and -manipulation rules. A

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[2] U.S. Congress, House Committee on Agriculture, *Commodity Futures Modernization Act*, Hearing 108th Cong., 1st sess., June 5 and 19, 2003, and U.S. Congress, Senate Committee on Agriculture, Forestry, and Nutrition, *Review of Commodity Futures Trading Commission Regulatory Issues*, hearing, 108th Cong., 2nd sess., May 13, 2004.

particular focus of these arguments is the over-the-counter (OTC) market for energy derivatives, which under the CFMA is subject to very limited oversight. During the 108th Congress, the Senate twice voted down measures to give the CFTC more regulatory powers, such as the authority to collect market data from traders in OTC energy contracts.[3] Similar legislation — H.R. 1638, H.R. 5248, S. 509, and S. 2642 — was introduced in the 109th Congress, but not enacted.

Others maintain that regulators already have sufficient authority to investigate and punish fraud, and that price volatility itself is not evidence of manipulation. CFTC chairmen have repeatedly rejected the view that new legislation is needed. In a 2004 speech, acting chairman Sharon Brown-Hruska defended the CFTC's enforcement record, pointing to actions taken against false reporting of natural gas prices and market manipulation by Enron and others: "In my mind, this era in which many acted with a lack of integrity and violated the law will soon be a part of history — one that will not be repeated as a result of our enforcement actions."[4]

S. 1566 as reported proposed to raise civil and criminal penalties for manipulation (or attempted manipulation) of commodity prices. The bill also sought to clarify that the CFTC's antifraud authority applies to "principal-to-principal" off-exchange derivatives contracts, including energy transactions.

H.R. 4473 would have required persons holding large quantities of natural gas contracts to maintain records and gives the CFTC access to such records as needed to investigate or deter manipulation. The bill also raised civil and criminal penalties for price manipulation.

Security Futures

Security futures are futures contracts based on single stocks or narrow-based stock indexes. Until the CFMA, these contracts were not permitted, largely because of concerns that they might be used to manipulate stock prices. The CFMA provided for joint regulation of the new contracts by the Securities and Exchange Commission (SEC) and the CFTC. Perhaps as a result, the process of writing trading rules was slow: the first contracts were not traded until 2003.

Trading volumes in security futures trading remain very low relative to the stock option market. The only currently active market is OneChicago, a joint venture between the Chicago Board of Trade (CBOT), the Chicago Mercantile Exchange (CME), and the Chicago Board Options Exchange (CBOE). During 2005, a total of about 5.5 million security futures contracts were traded. By contrast, *daily* option volume on the CBOE in 2005 was 1.9 million contracts.

Single-stock futures volume may continue to grow — 2005 volume was more than double that of 2004, and the first half of 2006 was up 51% over the same period in 2005

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[3] S.Amdt. 876 and S.Amdt. 2083. See CRS Report RS21401, *Regulation of Energy Derivatives*, by Mark Jickling.

[4] Speech by CFTC Acting Chairman Sharon Brown-Hruska, to the International Swaps and Derivatives Association (ISDA), New York, Nov. 17, 2004.

— but it will be difficult to compete with the highly liquid and well-developed stock options market, which offers contracts that permit most (if not all) the investment strategies that security futures do. On the other hand, it is not uncommon for new futures contracts to fail to excite enough trading interest to sustain themselves; this is still a possible fate for security futures.

During the reauthorization hearings in March 2005, several witnesses argued that the dual regulatory regime is cumbersome and hampers trading. CFTC Chairman Brown-Hruska stated that the CFTC would continue to work with the SEC to reduce duplicative regulation. Representatives of the Chicago futures exchanges called for an amendment to the CFMA to allow security futures to trade like any other futures contract. This would set aside the joint CFTC/SEC oversight arrangement and allow the futures exchanges to set margin requirements on security futures, as they do on all other futures contracts.[5] (At present, margins are set at 20% of the underlying stocks' value, a figure that was determined by the SEC and CFTC to be comparable to margin requirements on stock options, as the CFMA requires, but which is much higher than most futures margins, which generally are in the range of 3%-5% of the value of the underlying commodity.) By reducing margin requirements, the exchanges would lower the cost of trading security futures and would likely boost trading volumes. However, such a move would be resisted by the options exchanges, who would argue unfair competition, and by the SEC, which would be concerned about the possibility of manipulation of stock prices.

Section 7 of S. 1566 provided for a two-year pilot program, during which the futures exchanges would be able to set margins on security futures. Potentially, margins could be set much lower than the current 20%, lowering the costs of trading security futures. The provision was controversial because it appeared to undercut SEC jurisdiction over security futures, in addition to the competitive and market integrity concerns mentioned above. The Senate Banking Committee held a hearing on this issue on September 8, 2005, where Robert Colby of the SEC expressed concern that the bill's provisions could compromise investor protection and market integrity.

Section 103 of H.R. 4473 directed the CFTC and SEC to permit risk-based, or portfolio margining, for security futures by September 30, 2006.[6] This would have the effect of lowering margins for traders with partially offsetting positions in stock options and securities futures, but would likely result in a much less dramatic reduction overall. The House bill would have preserved SEC jurisdiction.

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[5] In futures contracts, "margin" is the amount of money that a customer must deposit with a broker in order to maintain a position in the market. Margin serves to protect the broker and the exchange from the risk of customer default. If margins are set too high, trading becomes too expensive and volume drops. If they are too low, exchange members and the clearing house are vulnerable to credit (or default) risk.

[6] In portfolio margining, margin is assessed according to the risk of an entire portfolio of assets, rather than on the risks of each element in the portfolio considered in isolation. Thus, for example, a trader with a short position in stock options and a long position in security futures would face lower margin calls under portfolio margining to the extent that one position would rise in value when the other was losing value. That is, the risks of the two positions were offsetting.

Retail Foreign Exchange Contracts

The Commodity Exchange Act generally prohibits the selling of off-exchange futures contracts to small "retail" investors. There has been some dispute over whether this prohibition applies to contracts based on foreign currency rates. In 1974, Congress exempted contracts based on foreign exchange and Treasury securities from CFTC regulation (the so-called Treasury Amendment). The CFTC has long argued that this exemption applied only to professional markets, and that it had authority to prevent the sale of futures-like contracts to small investors. The CFMA addressed this question, and the CFTC believed it had been given clear authority, but a 2004 federal court case[7] held that certain retail foreign exchange contracts were not futures contracts and could be legally sold. In 2005 hearings, CFTC Chairman Brown-Hruska suggested that additional legal authority or clarification might be needed to protect small investors from fraud.

Both House and Senate reauthorization bills in the 109th Congress sought to clarify the CFTC's authority over retail agreements and contracts in foreign currency. S. 1566 as reported included provisions designed to address the impact of the Zelener decision, specifying that the CFTC has jurisdiction over foreign exchange contracts offered to retail customers that feature margin or leveraged financing, and that are entered into for reasons other than commercial or personal use of a foreign currency (that is, speculative contracts).

In testimony before the Senate Banking Committee on September 8, 2005, the President's Working Group on Financial Markets (representing the Federal Reserve, the Treasury, the SEC, and the CFTC) recommended that the retail foreign exchange language in S. 1566 be amended to ensure that it did not inadvertently impose restrictions on large foreign exchange contracts traded by banks and other institutional investors. A floor amendment satisfactory to all regulators was expected to be offered by Chairman Chambliss of the Agriculture Committee and Chairman Shelby of the Banking Committee. However, S. 1566 never reached the Senate floor during the 109th Congress.

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[7] *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004).