

CRS Report for Congress

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CFTC Reauthorization in 2005

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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 House and Senate Agriculture Committees held reauthorization hearings in March 2005. The Senate Banking Committee held a hearing on September 8, 2005. The Senate Agriculture Committee approved S. 1566, a CFTC reauthorization bill offered by Chairman Chambliss, on July 21, 2005. This report provides brief summaries of the issues in the 2005 reauthorization legislation, including (1) 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 had hoped, (2) regulation of energy derivatives markets, where some see excessive price volatility and a lack of effective regulation, and (3) the legality of futures-like contracts based on foreign currency prices offered to retail investors.

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 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 public benefits to speculation: speculators provide liquidity that enables hedgers to take positions quickly and at low cost and to unwind those positions at any time. Speculative trading also provides a very effective price discovery mechanism: 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. Since 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. Federal Reserve Chairman Alan Greenspan frequently describes 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? 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 markets were 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 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 exchanges and the OTC markets have experienced strong growth in trading volumes since 2000.

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

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.

Issues for 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, it does not appear likely that another thorough overhaul of the CEA is in prospect for 2005. Several members of the House Agriculture Committee, in fact, expressed support for a one-line reauthorization bill that made no amendments to the CEA. During hearings before the House and Senate Agriculture Committees in March 2005, 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 are summarized briefly below.

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 could 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. 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 the third quarter of 2005, average daily volume was 28,090 security futures contracts. By contrast, 41.2 million stock options were traded daily in September 2005 on the CBOE.

Single-stock futures volume may continue to grow — 2005 volume is more than double that of 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.

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.

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 allow the exchanges to set margin requirements on security futures, as they do on all other futures contracts.³ (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 perhaps by the SEC, which would be concerned about the possibility of manipulation of stock prices.

Section 7 of S. 1566 provides 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 is controversial because it appears 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.

Energy Derivatives

Energy markets have seen turmoil in recent years: prices have been 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. Natural gas markets have experienced several price spikes, attributed to the market reaction to 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 a limit on the size of speculative futures positions.⁴

³ 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.

⁴ See, e.g., the testimony of Oliver Ireland, on behalf of Huntsman Chemical, a member of the Industrial Energy Consumers of America, before the Senate Committee on Agriculture, Forestry, and Nutrition, Mar. 10, 2005.

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 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.⁵ Similar legislation — H.R. 1638 and S. 509 — has been introduced in the 109th Congress.

Others, including the CFTC, 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."⁶

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

H.R. 3863, the Gasoline for America's Security Act, which passed the House on October 7, 2005, would direct the Federal Trade Commission to study the trading of refined petroleum products on the Nymex futures exchange. Matters to be addressed by the study include the price effects of Nymex contract specifications and the effectiveness of temporary trading halts.

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 case⁷ held that certain retail foreign exchange contracts were not futures contracts and could be legally traded. In 2005 hearings, CFTC Chairman Brown-Hruska suggested that

⁵ S.Amdt. 876 and S.Amdt. 2083. See CRS Report RS21401, *Regulation of Energy Derivatives*, by Mark Jickling.

⁶ Speech by CFTC Acting Chairman Sharon Brown-Hruska, to the International Swaps and Derivatives Association (ISDA), New York, Nov. 17, 2004.

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

additional legal authority or clarification might be needed to protect small investors from fraud.

S. 1566 includes provisions (in Section 4) 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.