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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.

In the 110th Congress, CFTC reauthorization provisions were added to the Farm Bill (H.R. 2419) and enacted over the President's veto on May 22, 2008, as P.L. 110-234. This report provides brief summaries of the issues addressed in that law, 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 energy, agricultural, and other markets.

The public interest in regulating derivatives markets flows from these two functions: price discovery and risk transfer. 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]

But although derivatives markets may generally support stability and resilience, they also enable very high-risk speculative strategies, which at times may pose a threat to financial stability. 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. As a result, the CFMA did not provide a statutory exemption for OTC agricultural derivatives. The derivatives market in farm commodities is dominated by exchange-traded futures contracts.

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

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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.

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.

Reauthorization in the 110th Congress

Given the CFTC's satisfaction with its role under the CFMA, the growth of trading volumes, and continued innovation in the markets, few in the Congress saw the need for another thorough overhaul of 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 were addressed by the reauthorization legislation enacted by the 110th Congress — title XIII of the Farm Bill (P.L. 110-234, H.R. 2419), enacted over the President's veto on May 22, 2008, and authorizing appropriations for the CFTC through FY2012. Major provisions are summarized below.

Energy Derivatives

Energy markets have seen turmoil in recent years: prices have been high and unusually volatile, there have been numerous episodes of fraud, and many suspect that energy prices have been driven artificially high by excessive speculation. 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 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 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.

In August 2006, the Amaranth hedge fund lost $2 billion in natural gas derivatives, and liquidated its entire $8 billion portfolio. A June 2007 staff report by the Senate Permanent Subcommittee on Investigations ("Excessive Speculation in the Natural Gas Market") found that the fund's collapse triggered a steep, unexpected decline in prices, and that Amaranth's large positions had caused significant price movements in the months before it failed. The report concludes that Amaranth was able to evade limits on the size of speculative positions (a key feature of the futures exchanges' anti-manipulation program) by shifting its trading from Nymex to exempt and unregulated markets.

The reauthorization legislation creates a new regulatory regime for certain OTC energy derivatives markets, subjecting them to a number of exchange-like regulations.

The provisions would apply to "electronic trading facilities" — markets where multiple buyers and sellers are able to post orders and execute transactions over an electronic network. If the CFTC determines that these markets, currently exempt from most regulation, play a significant role in setting energy prices, they will be required to register with the CFTC and comply with several regulatory core principles aimed at curbing manipulation and excessive speculation. They will be required to publish and/or report to the CFTC information relating to prices, trading volume, and size of positions held by speculators and hedgers.

These new regulatory requirements apply only to electronic markets that have come to resemble the regulated futures exchanges. Bilateral OTC derivative contracts between two principals (e.g., between a swap dealer and an institutional investor customer), that are not executed on a trading facility where multiple bids and offers are displayed, will continue to be largely exempt from CFTC regulation.

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 2007, a total of about 8.1 million security futures contracts were traded. By contrast, 2007 stock option volume on the CBOE in 2007 was 944.5 million contracts.

Single-stock futures volume may continue to grow but the product has had difficulty competing 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.

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.[2] (At present, margins are set at 20% of the underlying stocks' value, a figure that was

[2] 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.

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%-8% 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 13106 of the reauthorization legislation directs the CFTC and SEC to permit risk-based, or portfolio margining, for security futures by September 30, 2009. This would have the effect of lowering margins for traders with partially offsetting positions in stock options and securities futures, and would reduce trading costs somewhat. The agencies are further directed to permit trading in futures based on certain foreign stock indexes, also by September 30, 2009.

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

The 110th Congress legislation contains provisions similar to this regulatory agreement, clarifying the CFTC's authority over retail contracts and preserving the ability of banks and other financial institutions to continue their foreign exchange trading without CFTC regulation.