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REVIEW OF THE COMMODITY FUTURES TRADING COMMISSION'S DISCRETION TO EXEMPT CERTAIN TRANSACTIONS FROM ANTIFRAUD PROVISIONS OF THE COMMODITY EXCHANGE ACT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ENVIRONMENT, CREDIT, AND RURAL DEVELOPMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

H.R. 2374

TO AMEND THE COMMODITY EXCHANGE ACT TO ENSURE THE CONTINUED APPLICATION OF THE ACT'S ANTIFRAUD AND ANTIMANIPULATION PROTECTIONS

APRIL 28 AND JUNE 30, 1993

Serial No. 103–13

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April 28, 1993

REVIEW OF THE COMMODITY FUTURES TRADING COMMISSION'S DISCRETION TO EXEMPT CERTAIN TRANSACTIONS FROM ANTIFRAUD PROVISIONS OF THE COMMODITY EXCHANGE ACT

WEDNESDAY, APRIL 28, 1993

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ENVIRONMENT, CREDIT,
AND RURAL DEVELOPMENT,
COMMITTEE ON AGRICULTURE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 1300, Longworth House Office Building, Hon. Glenn English (chairman of the subcommittee) presiding.

Present: Representatives Long, Barlow, Holden, Combest, Gunderson, Allard, Nussle, and Ewing.

Also present: Representative E (Kika) de la Garza, chairman of the committee.

Staff present: Vernie Hubert, chief counsel and legislative director; Fred J. Clark, deputy chief counsel; John E. Hogan, minority counsel; Glenda L. Temple, clerk; Benjamin I. Baker, James E. McDonald, James A. Davis, John Riley, and David Ebersole.

OPENING STATEMENT OF HON. GLENN ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. ENGLISH. The hearing will now come to order.

Last year with the reauthorization of the Commodity Futures Trading Commission, the Congress wrestled with a very difficult issue of what we do pertaining to the so-called "derivatives." Our concern was that this was an issue in which we were not prepared to make a decision, and as such, we had requested that studies be done—studies that paralleled a study already underway by the General Accounting Office.

We requested the Securities and Exchange Commission, as well as the Federal Reserve and CFTC, to carry out studies pertaining to these derivatives, and we also pointed out that we did not want any action taken beyond maintaining the status quo. This was a decision that the Congress was reserving for itself, as to what should be done. The Congress has not yet reached that point, or reached that decision.

In maintaining that status quo, the Congress did grant authority to the CFTC to make sure that the courts did not act in preempting this decision, but it was made very clear that this was the decision to maintain the status quo only, not go beyond that point.

And at the time, I believe, I made the statement to the conference that as far as I was concerned, should action go beyond maintaining the status quo, that those who were involved would have the opportunity to explain their decision to this subcommittee, and it appears that that's where we are.

The so-called *Brent Oil* decision was the judgment that we recognized needed to be addressed. We recognized that there was the danger of the courts acting, and that it would also cause difficulty as far as the oil markets are concerned. We had, in fact, instructed the CFTC to take whatever actions necessary to maintain the status quo at that time.

There was a request made in November, with regard to exemptions. Those requests were considered by the CFTC, and from what I understand—if I'm in error, we'll let the Commission correct me—that the former chairman then provided to the Federal Register a proposal for a rule that had not even been considered or looked at by the other Commissioners, from what I understand.

It is disturbing then that earlier this month, we found newspaper headlines which told us that the former chairman, shortly after the publishing of that proposal in the Federal Register, joined one of the very companies, who in November came before the Commission.

It is my understanding then that the action taken by the Commission earlier this month was along those lines, and went beyond simply maintaining the status quo.

For the first time, we have a regulatory body that exempts those that they're regulating from fraud statutes, and while there is an inclusion of antimanipulation, there's a question as to whether or not it applies to the instruments that are being considered, since under the law—particular provisions under the law for manipulation apply to futures contracts.

We also find that this is a Commission that does not have a full compliment of members, and this was a two to one decision. I did note with interest that the only attorney on the Commission voted against it. I also have taken note of the fact that we have a memorandum to the files dated April 8 of this year, from the Director of the Division of Trading and Marketing, voicing concerns about this particular provision, and particularly the antifraud provisions.

We also have another memo to the Director of the Economic Division—from the Director of the Division on Enforcement—who voiced his concerns with regard to this action. It was noted by all three of those who I mentioned—the Director of Trading and Marketing, the Director of the Division on Economic Analysis, as well as the Commissioner—that the purpose of the legislation last year was to take us beyond an "all or nothing" position to not require the Commission to view each decision on that basis, and that this exceeded and went beyond what was intended, and I don't think there's any question about that.

At no time during the discussion of the reauthorization of the CFTC—certainly in the House, and I don't believe, in the other body—did we ever have any Member who raised the question or the wisdom of excluding any contract from fraud statutes of the

Federal Government or the regulatory body involved, and as was pointed out by the Director of the Division of Trading and Marketing, "To my knowledge, the Commission has never before exempted transactions in products subject to its jurisdiction from the antifraud provisions of the act, unless another regulatory regime clearly applied to such transactions."

What is more disturbing is that this action by the Commission may go beyond simply Federal law, and again, I quote the Director in pointing out that, "In this case, the energy contracts exempted from the CEA would also be exempt from State antibucketing laws, and to the extent that they are not investment contracts or securities, or can be so designed, it would be exempt from security laws as well."

I know that we will be provided with an explanation as to why it was necessary to take this action, and I have to say that I, for one, have been anxiously looking forward to the explanation.

[The prepared statement of Mr. English follows:]

STATEMENT OF CONGRESSMAN GLENN ENGLISH, CHAIRMAN
SUBCOMMITTEE ON ENVIRONMENT, CREDIT AND RURAL DEVELOPMENT

OVERSIGHT HEARING ON AN ORDER OF THE
THE COMMODITY FUTURES TRADING COMMISSION
EXEMPTING CERTAIN ENERGY CONTRACT FROM
PROVISIONS OF THE COMMODITY EXCHANGE ACT

April 28, 1993

Today the Subcommittee is holding an oversight hearing to review an order issued by the Commodity Futures Trading Commission on April 13, 1993, that exempted certain energy contracts from most of the provisions of the Commodity Exchange Act, including the Act's anti-fraud provisions.

The Commission's order was issued under an amendment to the Act enacted in the Futures Trading Practices Act of 1992 that added an new section 4(c). Section 4(c) authorizes the Commission to "exempt any agreement, contract, or transaction...either unconditionally or on stated terms or conditions...from any of the requirements of...subsection (a), or from any other provision of the Act...if the Commission determines that exemption would be consistent with the public interest."

The exemptive authority was granted to the Commission to enable it to provide legal certainty to a number of existing categories of instruments that have elements of futures contracts but do not trade on the regulated futures exchanges. The legal status of some of these contracts, including the 15-day Brent Oil contract, was questionable in light of various court decisions. Congress in granting the authority cautioned that the Commission should use this exemptive authority sparingly until Congress has had an opportunity to consider the results of various on-going studies of the fast-growing market in derivative instruments. However, the Conferees did recognize the need for the Commission to act promptly in four areas--hybrids, swaps, forwards, and deposits. The Commission previously granted exemptions applicable to hybrids, swaps, and deposits.

As previously noted, the Commission, prior to granting an exemption, is specifically required to find that the exemption is consistent with the public interest. The Conference report on the 1992 legislation make it clear that the public interest test includes the national public interests as noted in the Act, the prevention of fraud, and the financial integrity of the markets.

I believe that the report makes it quite clear that Congress did not expect the Commission to exempt instruments and contracts from the Act's anti-fraud provisions, unless there were extra-ordinary reasons for doing so. Today's witnesses will be given the opportunity to explain what the Commission believed those extra-ordinary reasons may be in the case of the exempted energy contracts -- especially since the heads of the Commission's Division of Enforcement and Division of Trading and Markets advised against exempting such contracts from the Act's anti-fraud provisions.

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, NW, Washington, DC 20581
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DIVISION OF
ENFORCEMENT

MEMORANDUM

April 8, 1993

TO: Gerry Gay, Director,
Division of Economic Analysis

FROM: Dennis Klejna, Director,
Division of Enforcement

RE: Exemption for Certain Contracts Involving Energy Products

This memorandum reiterates particular Division of Enforcement observations concerning the draft Commission order exempting certain energy contracts from most provisions of the Act.[1]

The primary focus of our observations is on the absence of retained anti-fraud jurisdiction under either Section 4b or Section 4o. The new exemptive authority granted by Congress frees the Commission from having to make the all or nothing jurisdictional decisions faced in the past. In this connection, we are not aware of any Securities and Exchange Commission exemption that excludes securities products from anti-fraud jurisdiction. See, e.g., Preliminary Note 1 to Regulation D, 17 C.F.R. § 230.501 et. seq. (1992)(registration exemption for limited offerings); Preliminary Note 1 to Rule 144A, 17 C.F.R. § 230.144A (1992)(registration exemption for certain private institutional resales); Preliminary Note 1 to Regulation S, 17 C.F.R. § 230.901 et. seq. (1992)(registration exemption for offers and sales outside the U.S.).

The lack of fraud jurisdiction over exempt contracts may become significant in two areas. First, the exemption will allow for indirect public participation through otherwise qualified pools, trusts, or partnerships. The Commission's own experience shows that it is difficult to predict the effect on retail customers of Commission relief granted primarily to institutions. In 1985, the Office of General Counsel issued Interpretative Letter 85-2 to a regulated bank. The letter opined that transactions entered into by the bank and retail metals dealers

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[1] The Division was consulted by the Division of Economic Analysis on the text of the order and the accompanying preamble, and some, but not all, Division comments were incorporated in that process.

were not futures, options, or leverage contracts. While the opinion appears legally correct, the result was the birth and proliferation of fraudulent sales operations that caused millions of dollars in retail customer losses and led to Congressional hearings.[2] Moreover, there is a nearly limitless variety of partnerships, trusts, or other business entities that could be formed to engage in exempt energy contracts, and it would not be difficult to structure such an entity to avoid securities laws.[3] We have not fully examined the myriad legal issues associated with applying federal securities laws or state blue sky laws to investment vehicles that could trade in exempt contracts, and Section 12(e) of the Act may prevent the application of state securities laws. It is also unclear how the Model State Commodity Code would be applied to vehicles for indirect public participation in the energy contract market.

In addition, the exemption would permit small businesses to qualify for participation in the energy contract market, which may raise policy issues about where the Commission wants to draw the line between large entities presumably capable of protecting themselves and smaller, albeit still "commercial," entities who may lack the acumen to judge complex derivative instruments.[4] The Commission already has seen one example of precious metals contracts marketed to small businesses in a scheme that ultimately resulted in retail customer losses and allegations of fraud. See Krommenhoek v. A-Mark Precious Metals, Inc., No. 90-35604 (9th Cir. Sept. 27, 1991).

As I have noted in past discussions, there may be legal obstacles to applying Section 4b to the contracts described in the draft exemption. By its terms, Section 4b applies only to futures contracts, and energy contracts would be subject to Section 4b only if it could be proved that they were futures contracts. Therefore, a court may not find those energy contracts that fall within the scope of the Brent Interp. to be futures contracts in light of the Brent Interp.'s unqualified nature. However, the draft exemption goes beyond the Brent Interp. -- indeed, the applicants have stated that it is their intention to expand on the Brent Interp. -- and it could be less difficult to apply Section 4b to those transactions that fall

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[2] See "The Scourge of Telemarketing Fraud: What Can be Done Against It?" H.R. Rep. 102-421 (102d Cong. 1st Sess. 1991).

[3] The SEC's problems in combatting "gold in the ground" schemes shows that commodity investments can be packaged to avoid SEC jurisdiction. See SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. (1986).

[4] In this regard, the Commission's "trade option exemption," which does apply to small businesses, does not exempt the subject transactions from fraud jurisdiction. See 17 C.F.R. § 32.4 (1992).

outside of the Brent Interp. but remain within the scope of the draft exemption.

Also, I understand that some have suggested that the "for or on behalf of" phrase in Section 4b could be construed to create a litigation obstacle to applying Section 4b to the type of principal to principal transaction primarily contemplated in the exemption. However, in many Commission enforcement actions, courts have readily applied Section 4b in off-exchange cases where boiler-rooms have sold their illegal contracts directly to customers. In any event, the draft exemption now specifically permits brokers or agents to facilitate energy contracts, the very type of brokerage activity that Section 4b appears intended to encompass.

Aside from the policy issues raised by not retaining anti-fraud jurisdiction over the contracts, a decision not to retain section 4o jurisdiction explicitly in the exemptive order could raise practical issues concerning the Commission's jurisdiction over pooled investment vehicles that engage in both exempted energy contracts and regulated futures or commodity options.[5] Where such persons or entities engage in fraud, the Commission may face the argument that it lacks jurisdiction to prosecute because the fraud is attributable in part or in whole to the CPO's or CTA's conduct in connection with an exempted energy contract. Thus, the Commission may face higher litigation costs in pursuing fraud, even where it appears that the fraud pervades an entire pool offering (for example, where false track record information distributed to all customers of a pool that engages in a variety of energy contracts is false because it conceals losses solely on exempted contracts, would 4o jurisdiction exist?).

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[5] A footnote in the preamble to the order addresses this issue, but the effect of the footnote in the face of unambiguous language in the order itself is questionable.

Mr. ENGLISH. Mr. Combest.

OPENING STATEMENT OF HON. LARRY COMBEST, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. COMBEST. Thank you, Mr. Chairman. Mr. Chairman, as you, possibly more than anyone else know, the Congress spent an inordinate amount of time debating and agonizing over the finer points of issues concerning the grant of certain exemptive authority to the Commodity Futures Trading Commission.

Frankly, I thought we'd put these issues aside, at least until various studies, reports, and papers had been published. We were waiting for these experts on all sides to make their cases concerning many unanswered questions.

These questions include what these many derivative products are, who should or should not be regulating them, and what is the risk to the world's financial and trading systems should the Congress decide to maintain the status quo?

I, too, am concerned that we not allow the Commission to get too far off the reservation on these matters that last year's conference committee agreed are difficult policy issues. They also may have unknown real world implications far beyond the politics of split regulatory and congressional jurisdictions.

Since last year's reauthorization granted the Commission the authority to make such exemptions, our subcommittee should show our concern for market integrity, while being careful not to second guess every decision made by the Commissioners within their authority.

Having said that though, I will reserve my judgment about whether or not the Commission made the correct decision in exempting participants from the antifraud provisions of section 4b of the Commodity Exchange Act.

I look forward to hearing the Commissioners' reasoning this morning. Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Gunderson.

Mr. GUNDERSON. No statement, Mr. Chairman.

Mr. ENGLISH. Today we will have a panel of witnesses, the three remaining members of the Commission—the three that participated in this decision. We will have the Honorable William Albrecht, who is the Acting Chairman, the Honorable Sheila Bair, who is a Commissioner, and the Honorable Joseph Dial, who is a Commissioner.

Mr. Albrecht, we'll let you begin with your testimony if you would, please.

STATEMENT OF WILLIAM P. ALBRECHT, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. ALBRECHT. Thank you. My written statement, which I submit for the record, discusses in some detail the statutory background, the nature of the energy exemption, and the rationale behind it.

In my remarks today, I will concentrate on two questions: Should the Commission have reserved the antifraud authority of section 4b of the Commodity Exchange Act, and how does our action fit into the broader mosaic of issues currently affecting United States and world financial markets.

Let me start with a few facts. On October 28, 1992, the Futures Trading Practices Act, or FTPA, gave the CFTC the authority to exempt given types of agreements from almost all of the requirements of the Commodity Exchange Act, including section 4b.

Neither the FTPA nor the accompanying conference report includes any separate discussion of 4b. The conference report does, however, specifically direct the Commission to consider the exemption under discussion today.

Consistent with that legislative direction, on January 19, 1993, the Commission voted to publish for comment the proposed order granting this exemption. The proposed order did not seek to retain 4b jurisdiction.

When this proposed order was published in the Federal Register on January 27, we specifically asked for comment on whether we should reserve the applicability of section 4b. Sixteen comment letters were received. None of them explicitly supported reserving 4b, and most argued against it.

On March 8, the Federal Register provided notice that the Commission would meet on April 6 to vote on a final order.

On April 1, the Federal Register provided notice that this meeting had been postponed until April 13.

On April 13, the Commission approved a final order that was much the same as the original proposal, and, in all respects, identical concerning section 4b.

In approving this order, I'm quite confident that we followed not only the letter of the law, but the spirit as well—the spirit of change embodied in our new exemptive authority.

The world of financial services has changed dramatically since the CFTC was established nearly 20 years ago. At that time, futures markets dealt primarily with agricultural products. The U.S. futures industry clearly dominated the world marketplace. There was no significant competition from over-the-counter products. It was easy to tell the difference between a "future" and a "forward." It was easy to tell the difference between a "future" and a "security." The distinctions among products were clear and meaningful.

Today, none of these conditions hold true. Financial markets have evolved at a breathtaking pace, and that evolution continues.

Last year, Mr. Chairman, under your leadership, Congress faced up to the realities of today's global marketplace. It recognized that a regulatory regime, based on the world of 20 years ago, was causing serious problems for derivative markets in the United States, and that it was hurting our international competitiveness.

Congress addressed this situation by passing the FTPA, and giving the CFTC the exemptive authority it so badly needed. The genius of this authority is that it frees us from the increasingly meaningless debate over whether something is a future or not. Instead, we can concentrate on designing the appropriate regulatory scheme for products that have futures-like characteristics.

We can consider how much regulation by the CFTC is needed based upon the characteristics of the market, such as the customer base, the market's purpose, the potential for fraud, and the availability of other governmental oversight.

For some products, such as the energy contracts under discussion today, this may mean almost no oversight by the CFTC. For others, such as swaps, we've decided to maintain more oversight. This authority also means that we can fashion different regulatory schemes for futures exchanges if that is appropriate.

As I stated in my recent remarks at the annual meeting of the Futures Industry Association, I believe that changes in technology, customers, and competition mean that we can lighten the regulatory burden on exchange traded products that are limited to appropriate persons, and offered through an electronic trading facility. This would be an important step for achieving the fair competition between exchanges and nonexchanges that Congress envisioned when it enacted the FTPA.

In the case of energy transactions, we have fashioned an exemption for a fundamentally commercial market, whose purpose is to move energy products in the stream of commerce. This market has been in operation for over a century, and has gotten along just fine without CFTC oversight. Its participants are large commercial entities, well aware of their contractual rights and legal remedies.

I am concerned that maintaining section 4b authority over this market would provide little, if any, benefit, and perhaps cause very real harm. If section 4b remains an issue, some international commercial participants will continue to refuse to do business with U.S. energy firms, and some U.S. firms will set up off-shore branches.

In short, retaining 4b authority will damage U.S. international competitiveness.

Let me emphasize, however, that the Commission's action does not signal any abandonment of the principles of section 4b. There has been no lessening of the CFTC's commitment to detect, deter, and punish fraudulent activities. We have simply made an informed judgment to devote our resources to those markets where they are most needed and most likely to be effective.

Last October, Congress gave the CFTC the power to change an outdated regulatory system. In November, the voters chose a new President, the President elected on the platform of change—a President whose campaign theme song was "Don't Stop Thinking About Tomorrow."

If America's financial services industry is to be an effective international competitor, if the CFTC is to be an effective regulator, we must let go of the past. We must forget about outdated jurisdictional battles and outdated regulatory schemes, and start thinking about tomorrow.

I believe that in adopting this energy exemption, the Commission has done exactly that.

[The prepared statement of Mr. Albrecht appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you.

Ms. Bair.

STATEMENT OF SHEILA C. BAIR, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Ms. BAIR. Thank you, Mr. Chairman, members of the subcommittee. Thank you for the opportunity to appear before you today to discuss the Commission's order of April 13 exempting certain energy contracts from the Commodity Exchange Act. I voted against this order.

As you know, it fails to retain the general antifraud provisions contained in sections 4b and 4o of the Commodity Exchange Act. I believe that exempting such transactions from statutory provisions so basic and central to our regulatory scheme is a serious misapplication of our new exemptive authority, and does set a dangerous precedent.

At the outset, let me emphasize that I do not challenge the Commission's legal authority to have granted energy contracts this exemption, as ill-advised as I feel that action was, nor do I oppose in concept an appropriately tailored exemption for the Brent Oil market.

As the members of this subcommittee are aware, in September 1990, the Commission issued a statutory interpretation determining Brent crude oil contracts were forward contracts excluded from the act. The Commission's action was prompted by a Federal district court holding in the *Transnor* case that Brent contracts were futures contracts subject to the CEA.

As former Commissioner Fowler West pointed out in his dissent, the statutory interpretation went far beyond generally accepted criteria in defining Brent contracts as forwards. Regrettably, the Commission had little choice but to take such an approach because then, unlike now, it lacked the authority to exempt futures contracts from the act.

Because the Brent statutory interpretation was such a departure from the traditional view of forwards, it left open the possibility that a court could disagree with it, and still find the Brent contracts were futures. Thus, it failed to provide the legal certainty which Brent market participants sought.

As result, I believe it would have been completely appropriate for the Commission to use its new exemptive authority to grant an exemption for the Brent Oil market, while retaining antifraud and antimanipulation authority. Unfortunately, the exemptive order approved by the Commission went far beyond what was necessary, and significantly expands the Commission's 1990 Brent Oil statutory interpretation.

For instance, the statutory interpretation was crafted to address contracts for delivery in the Brent Oil market where a single cargo consists of 500,000 barrels with a current market value in excess of $10 million. The exemptive order, on the other hand, encompasses any contract for crude oil, as well as condensates, natural gas, natural gas liquids, or any of their derivatives, regardless of the size of the transaction.

The exemptive order also significantly expands the types of offset arrangements that are covered. The statutory interpretation described arrangements requiring parties to negotiate offset arrangements subsequent to entering into a Brent contract. Thus, they retain significant delivery risk.

The exemptive order, on the other hand, recognizes master agreements where the presumption is that the parties will offset their transactions. Parties using these agreements can net all transactions in a particular month with no intention to take delivery of any amount of the underlying commodity.

In addition, the kinds of entities eligible under the exemptive order are significantly broader than those described in the statutory interpretation. The statutory interpretation described eligible participants as producers, processors, refiners, and merchandisers of petroleum products, and other entities that buy and sell petroleum in connection with a line of business.

Entities eligible to participate under the exemptive order, however, include, among others, banks and governmental entities, as well as business entities with a net worth exceeding $1 million, or total assets exceeding $5 million. It is unnecessary for a business to meet even these relatively low financial requirements if it can secure a guarantee or letter of credit from a number of enumerated entities, including a bank, savings and loan, broker-dealer, FCM—even a floor broker or floor trader.

A footnote to the exemptive order also makes clear that speculative investment vehicles, such as commodity pools, can qualify.

Finally, the exemptive order dilutes the commerciality requirement of the statutory interpretation to such an extent as to make it almost nonexistent. The statutory interpretation emphasized that transactions in Brent contracts are entered into for commercial purposes in normal commercial channels, and must be related to the business of the party.

The exemptive order, on the other hand, simply requires that energy contracts be entered into by "commercial participants who, in connection with their business activities, incur risk, in addition to price risk, related to the underlying physical commodities."

This sounds impressive, but a publicly offered commodity pool or a floor broker with a partial interest in a single oil well could, in good faith, claim that it has met the risk portion of this test.

Indeed, it can be argued that an entity becomes a commercial participant for purposes of the exemption, simply by entering into an exempt transaction. This is because the terms of an exempt energy contract expose the parties to the contract to the risk of owning the commodity.

In my view, the April 13 order is sufficiently broad as to easily extend to transactions traditionally viewed as illegal, off-exchange futures contracts under criteria applied by the Commission and the courts.

Given that fact, I believe it was important to the integrity of our enforcement program for the Commission to retain antifraud authority, and can see no valid policy reason for the Commission's refusal to do so.

One of the primary arguments that has been advanced for granting an exemption to the antifraud provisions of the act is that the participants in exempt energy transactions are sophisticated institutional users, or entities of high net worth, who do not need the antifraud protections of the act.

At the outset, I would note that if we are to rationalize exemptions from antifraud and other components of our regulatory scheme on the basis of the sophistication of market users, we might as well close our doors tomorrow because approximately 98 percent of users of regulated exchange traded futures are also sophisticated institutional users or entities of high net worth.

Additionally, we all know that large firms are defrauded. The Commission has brought or assisted in a number of actions where the victims have been so called, institutional or sophisticated investors.

Further, the Commission's exemptive order permits participation in exempt energy transactions by comparatively low net worth individuals or small businesses through the $1 million net worth threshold for corporations and proprietorships and the sweeping guarantee provisions. The participation of such entities not only undermines the sophisticated institution argument for an exemption from the antifraud provisions, it also increases the likelihood of exempt energy boilerrooms that target small business.

In addition, the order contemplates indirect public participation in exempt transactions through a footnote permitting collective investment vehicles such as commodity pools, but because the order fails to expressly retain section 4o authority, it is unclear if the Commission has the authority to sue a registered commodity pool operator for fraudulent representations to prospective pool investors concerning exempt energy transactions.

Another argument against retaining the antifraud provisions of the act is that it would place an onerous burden on the energy markets.

In response, I would first note that if the antifraud provisions of the act were retained, they would only apply to fraudulent transactions, which could also be shown to be futures contracts, otherwise subject to our jurisdiction under the act.

In addition, basic CEA antifraud protections apply no more of a burden on these markets than do State antifraud laws. Indeed, given conflicts in State law, providing Federal forums and remedies in connection with these transactions is, if anything, less onerous in forcing participants, many of which are not U.S. companies, to resolve their disputes under State law.

It should also be noted that at least some of the energy contracts exempted by the Commission are also already subject to regulation, including antifraud requirements, in the United Kingdom without any apparent chilling effect on market participation.

The Commission, I believe, has set a dangerous precedent by not retaining antifraud protections in this energy exemption. To my knowledge, it is unprecedented for the Commission to provide relief from antifraud protections for transactions that are not subject to the jurisdiction of another regulator.

The Commission retained antifraud authority for swap transactions which, like energy contracts, are principal-to-principal arrangements in which brokers are permitted to facilitate transactions.

What's more, the financial thresholds for eligible swap participants under the Commission's swaps rule are significantly higher than those required of eligible energy contract participants. Thus, the energy order, if anything, would seem to present a stronger case for retaining antifraud protections than the swaps rule.

Commission rules governing trade options, which are options offered to commercials in connection with their business, are also subject to an antifraud provision, and of course, retention of antifraud jurisdiction is standard in exemptions granted by the SEC.

By deviating from all of these precedents, my fear is that the Commission has raised the expectations of other potential applicants for exemptive relief, that they as well will be able to escape sections 4b and 4o.

The primary reason the CFTC sought general exemptive authority in its reauthorization was to have the flexibility to craft appropriately tailored exemptive relief based on public policy considerations, instead of continuing to deal with the "all or nothing" jurisdictional decisions forced upon us in the past.

In my view, we should have used our new exemptive authority to clean up the confusion regarding forward contracts created by the Brent Oil statutory interpretation, and I have no doubt that we could have designed an exemptive order sufficient to meet the needs of the Brent Oil market without compromising core provisions of the CEA.

Unfortunately, we have continued to follow the "all or nothing" approach, instead of weighing individual aspects of our regulatory structure and making a reasoned determination as to which requirements should apply.

That concludes my statement. Thank you, Mr. Chairman.

[The prepared statement of Ms. Bair appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much.

Mr. Dial.

STATEMENT OF JOSEPH B. DIAL, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Mr. DIAL. Thank you, Mr. Chairman, members of the subcommittee. As I stated in my concurring opinion to the exemptive order relating to certain energy contracts issued by the Commission on April 13, 1993, I believe that this exemption was unique, given its factual and legal background.

In my comments on the 13th, I expressed the belief that Congress intended to allow existing energy contract practices in these markets to continue to perform a useful function in the international marketplace.

I noted my belief then, and I respectfully submit to you today that the Commission was exercising its exemptive authority in a manner consistent with congressional intent.

From November 16, 1992, until April 13, 1993, I relied on the plain language of the Futures Trading Practices Act and the conferees' report as my guide in reaching a decision on the energy proposal.

There are seven factors explicitly stated in the statute and conference report that I referred to from time to time, again and again:

First, the conference report to the Futures Trading Practices Act of 1992, in a paragraph in the exemptive authority section entitled "Forwards," specifically provided that "[T]he conferees encourage the Commission to review the situation and these contracts to determine whether exemptive or other action should be taken." We did that.

Second, the conferees indicated that the exemptive authority should be used to "create legal certainty for a number of existing categories of instruments, which trade today, outside of the forum of a designated contract market." We took that into consideration as it was written.

Third, the conferees further stated that the Commission should use the exemptive authority promptly in the "areas where significant concerns of legal uncertainty have arisen," including among others, forwards. We acted promptly.

Fourth, the conferees specifically did not express a view regarding the applicability of the Commission's Brent interpretation.

Fifth, the conferees expressly stated that the exercise of this exemptive authority would not "require any determination beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the act."

Sixth, the FTPA provides that the Commission may exempt an agreement, contract, or transaction from section 4(a) of the Act "or from any other provision of this act, except section 2(a)(1)(b), if the Commission determines that the exemption would be consistent with the public interest." We acted in accordance with those instructions.

Seventh, the conferees stated that the public interest test should "include the national public interest noted in the act, the prevention of fraud, and the preservation of the financial integrity of markets, as well as the promotion of responsible economic or financial innovation and fair competition." We also tried to find proper balance in complying with these instructions.

Given each of these factors, it remains my determination that the exemptive order, as approved by the Commission, was appropriate. The conferees chose to allow our prior statutory interpretation concerning forward transactions to stand.

Furthermore, the language of the conference report clearly states that CFTC does not have to find a contract within our jurisdiction in order to exempt it.

Accordingly, I voted to provide the requested relief to existing forwards-like markets, which could arguably come under the penumbra of the Brent interpretation, believing we should treat these more "as excluded forwards" than as "exempted futures." As such, I made the decision that the application of section 4b to these contracts was inapposite.

I base this decision, in part, on my understanding of the legislative intent regarding regulation of forwards contracts. The section 2(a)(1) exclusion for such contracts was grounded on the premise that "the act's regulatory scheme for futures trading simply should not apply to private, commercial merchandizing transactions which created enforceable obligations to deliver, but in which delivery is deferred for reasons of commercial convenience or necessity."

That interpretation described the Commission's determination as to what commercial-to-commercial transactions involving commodities it considers to be within the scope of the section 2(a)(1) exclusion.

Included within that scope of exclusions are "transactions which create specific delivery obligations, * * * [which] create substantial economic risk of a commercial nature to the parties * * *."

I believe that the contracts, which were the subject of the April 13, 1993 exemptive order, were sufficiently within the penumbra of the Brent interpretation, so as to warrant similar treatment. These contracts are restricted to commercial entities and create delivery obligations that entail market risk.

Even though the parties may enter subsequent contracts to discharge the obligations, this does not nullify the market risk attendant to these transactions.

Similarly, even though the parties may satisfy the capacity requirement of the exemption by executing bona fide contracts for services such as production, refining, or storage, this still requires the ability to bear market risk involved with the transactions.

Accordingly, I believe that the exemptive authority sufficiently delimited the relief to existing markets, which come within the general categories specified in the conference report paragraph noted above, entitled "Forwards."

This, I believe, indicates that the fraud protection available to current participants in the forwards market is sufficient for contracts included in the exemptive order, and renders the application of section 4b inappropriate.

I took this into account in reviewing the various components of the public interest test, and I came to the decision to support the energy exemption order as it was approved, after carefully reviewing the nature of the relief requested, the existing markets, the above-mentioned directives of the conference report, and the statute.

Thank you, sir.

[The prepared statement of Mr. Dial appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you, Mr. Dial.

The very purpose for the existence for the Commodity Futures Trading Commission or any other Government regulatory agency is to protect the public interest.

Mr. Albrecht, can you explain to me how opening the door to fraud protects the public interest?

Mr. ALBRECHT. I think that we should first be clear on a couple of facts: That essentially, what we have done is to maintain the status quo in exercising our exemptive authority. We've attempted to write a rule which leaves a market free from CFTC's jurisdiction, which is currently free from that jurisdiction.

The question is, should the specific antifraud prohibitions of the Commodity Exchange Act, as enforced by the CFTC, apply to this market?

There are lots of markets in which there is no oversight by the CFTC, nor by any other governmental regulatory agency. There is, however, a Department of Justice, which enforces Federal antifraud statutes, there are State laws which enforce State antifraud statutes, and there are civil remedies available for fraud.

The question is not, are we condoning fraud? The question is not, are we repealing antifraud statutes? We're simply saying, here is a market in which there are laws against fraud. The CFTC has never overseen this market.

We do not think that it would be in the public interest to extend our antifraud jurisdiction to that market for the reasons that I've outlined—I'd be happy to go through again.

Mr. ENGLISH. Mr. Albrecht, that was not the question. The question I asked you goes to the very core of the existence of the CFTC.

It was not your decision to make, nor were you a party to the creation of the CFTC or the need for it, and certainly, it is not up to you to make the decisions with regard to whether it needs to exist.

It does exist because it has been determined by the people who have the responsibility to make the laws of this country, there's a need for it, not that some other governmental body can do it, and we don't need it.

The bottom line question, again, is, given the requirements under the law to meet the interest of the public—a public interest test—how can you justify opening the door to fraud in these markets?

Mr. ALBRECHT. I simply have to take serious exception to the way the question is stated. I do not believe that we have opened the door to serious fraud. That simply is not true.

Mr. ENGLISH. Mr. Albrecht, I don't see how it can be looked at in any other way. Whenever you take it upon yourselves to exempt a market from the fraud requirements of the agency, that opens the door to fraud. There can be no other interpretation.

Now, we may argue as to whether or not there should or should not be a CFTC, or whether there should or should not be any kind of governmental agency overseeing particular markets, but the fact of the matter is that unless you have—any time that you have been charged with the responsibility of carrying out the laws and protecting the public interest, I see no way in which you can justify lifting the requirements of the law exempting a market from the fraud requirements of that agency. That is not in the public interest.

Mr. ALBRECHT. Let me repeat one point that I made earlier——

Mr. ENGLISH. I'm not asking you to repeat the point, I'm asking you to answer the question.

Mr. ALBRECHT. I'm trying to answer your question, sir. I believe this is responsive to your question.

I do not believe that we have lifted fraud requirements from the market. The market is subject to no more and no less fraud oversight on April 14 than it was on April 12, but let me address the—perhaps, this will help answer the question.

Mr. ENGLISH. Well, let's follow-up on that part right there. You're saying that it is subject to no more applications under the law on April 14 than it was on April 12?

Mr. ALBRECHT. Yes, sir.

Mr. ENGLISH. In what way?

Mr. ALBRECHT. On April 12, the CFTC did not have jurisdiction over these energy contracts—they never exerted that. On April 13, we voted to maintain that position.

Mr. ENGLISH. Well, explain to me then, Mr. Albrecht, how in the world a Government agency—how you, as a regulator, can exempt someone over which you have no jurisdiction, if that is your position.

Mr. ALBRECHT. I believe that is the heart and soul of this exemptive authority. Some people have said the CFTC may have jurisdiction over this market—some people have said, "These may be futures——

Mr. ENGLISH. Are you talking about people, or are you talking about courts?

Mr. ALBRECHT. People—courts——

Mr. ENGLISH. Yes—they're all the same, in your opinion?

Mr. ALBRECHT. Well, judges are people, but—if the court——

Mr. ENGLISH. Well, let's use—yes. The court has decided.

Mr. ALBRECHT. The court has said so, and——

Mr. ENGLISH. And you disagree?

Mr. ALBRECHT. A court said that——

Mr. ENGLISH. Do you disagree with that court?

Mr. ALBRECHT. Yes.

Mr. ENGLISH. So you do not believe that the courts are correct.

Mr. ALBRECHT. I believe, in that particular case, that particular court made an incorrect decision.

Mr. ENGLISH. And you have chosen to overrule the court, is that correct?

Mr. ALBRECHT. It's not in my power to overrule the court.

Mr. ENGLISH. It is also not in your power to exempt from the statutes, an entity over which you have no regulatory authority. Is that not correct?

Mr. ALBRECHT. As I understand——

Mr. ENGLISH. Will you answer my question, please?

Mr. ALBRECHT. I'm trying to answer your question.

Mr. ENGLISH. Well, either yes or no. Do you have the authority to exempt from the statutes, an entity over which you have no regulatory authority?

Mr. ALBRECHT. Congress granted us the authority to exempt markets without making the determination as to whether they were subject to our authority, so the answer is yes.

Mr. ENGLISH. So you have the authority to exempt—are you an attorney, Mr. Albrecht?

Mr. ALBRECHT. I am not an attorney. I work with a lot of attorneys. I've received a lot of advice on this question from attorneys.

Mr. ENGLISH. Ms. Bair, you are an attorney?

Ms. BAIR. Yes, sir.

Mr. ENGLISH. Mr. Dial, you're not an attorney?

Mr. DIAL. No, sir. I am not.

Mr. ENGLISH. Ms. Bair, under the law—I'm not an attorney either. Maybe you could help us with a little legal work here then. Under the law, is it possible for someone to exempt from the statutes, if they have no authority over that entity?

Ms. BAIR. No, sir. I don't believe it is, and to the extent we are exempting things that are futures contracts, and therefore, are otherwise subject to the Commodity Exchange.

Mr. ENGLISH. So if these are not futures contracts, there's no authority.

Ms. BAIR. That's right. We cannot exempt something that's not within our jurisdiction in the first place.

Mr. ENGLISH. OK.

Ms. BAIR. In my view.

Mr. ENGLISH. Mr. Albrecht, that brings us back to the point. We have the attorney here—your counsel on the Commission—who advises you that you can't exempt something that is not, in fact, covered under your jurisdiction.

Mr. ALBRECHT. Commissioner Bair is not my counsel. I have counsel who advise me otherwise.

Mr. ENGLISH. Oh, you get your own lawyer's advice. You get your own counsel then, is that right?

Mr. ALBRECHT. As I think you well know, each Commissioner has legal staff assigned to him. We have a number of attorneys within the Commission. I rely upon them for advice.

I believe that they have told me that the conference report and Commissioner Bair's statement are inconsistent.

Mr. ENGLISH. You also had recommendations or views being expressed by both the Director of Enforcement and the Director of the Division of Trading and Markets, is that right—on this issue?

Mr. ALBRECHT. Yes. But those were documents which were not sent to the Commission. We forwarded them to you because we wanted to send as much material as we could on this.

Mr. ENGLISH. You're telling me then that these people did not advise you of their views?

Mr. ALBRECHT. They did advise us of their views.

Mr. ENGLISH. So you were aware of these views.

Mr. ALBRECHT. I was aware of these views.

Mr. ENGLISH. And both had advised you of problems that they saw with taking this action, is that correct?

Mr. ALBRECHT. I think it would be useful to——

Mr. ENGLISH. Well, just answer the question, Mr. Albrecht. Is that right or not? Yes or no?

Mr. ALBRECHT. Yes.

Mr. ENGLISH. So you had both the Director of Enforcement of the Division of Enforcement and the Director on the Division of Trading and Marketing, who advised you that they saw problems with regard to this matter, and even under the provisions of the law—the basic responsibility that you have to protect the public interest—you saw fit to move ahead, even over the reservations and concerns being expressed by the only attorney sitting on the Commission itself?

Mr. ALBRECHT. Well, that's an incorrect statement. They are not——

Mr. ENGLISH. Tell me who in the Commission was recommending that—who, with regard to the staff in the Commission, was——

Mr. ALBRECHT. The General Counsel, which is an office full of attorneys. The General Counsel herself is also an attorney.

Mr. ENGLISH. I thought the General Counsel's place was to advise you what was legal and what's not. Is it also the General Counsel's position to advise you what's good policy and what's not—what's in the public interest and what's not?

Mr. ALBRECHT. The purpose of every division Director is to give the full Commission their views on issues before us.

Mr. ENGLISH. Whether they have any expertise or not.

Mr. ALBRECHT. Does who have any expertise?

Mr. ENGLISH. Whether the division has any expertise or——

Mr. ALBRECHT. They all have expertise, and——

Mr. ENGLISH. They all have expertise in every field that is within the Commission, is that correct?

Mr. ALBRECHT. On most issues——

Mr. ENGLISH. Does your legal counsel have that kind of expertise to what, in fact, is a problem from an enforcement standpoint, or what, in fact, is good policy?

Mr. ALBRECHT. I believe so. I believe that—if I may be permitted, sir—I believe that each division Director has expertise over a wide range of issues.

Now each division Director is most particularly concerned about a particular aspect of Commission policy—but they are staff.

They are, by and large, career bureaucrats. They don't have to make the policy decisions.

They make the recommendations, and we make the policy decisions. They make the recommendations from their perspective.

As it turns out, of the four major division Directors, two supported what we did, two would have preferred that we keep section 4b in.

I should also note that those——

Mr. ENGLISH. Well, who are the two? You've mentioned your legal counsel—is that your personal legal counsel? Is that a head of a department or—what?

Mr. ALBRECHT. The General Counsel, who is a head of a division, and——

Mr. ENGLISH. Is that your personal counsel?

Mr. ALBRECHT. No, sir.

Mr. ENGLISH. How many lawyers do you have over there?

Mr. ALBRECHT. On the Commission staff?

Mr. ENGLISH. Advising you personally.

Mr. ALBRECHT. I have two lawyers on my own staff——

Mr. ENGLISH. And then you have a division of lawyers?

Mr. ALBRECHT. We have a lot of lawyers. We probably have about 125 lawyers at the Commission.

Mr. ENGLISH. Well, that may be part of the problem right there.

Mr. ALBRECHT. I've been known to say that. [Laughter.]

Mr. ENGLISH. Well, you may have been right. [Laughter.]

Who's this other division head that was supporting—who didn't feel we needed any fraud statutes?

Mr. ALBRECHT. That's our Chief Economist.

Mr. ENGLISH. So you have the economist and your head lawyer, who have said that they thought this was a great idea—"We don't need any fraud statutes."

You have the head of the Division of Enforcement, and the head of Trading and Markets, who say they think it's a bad idea.

Mr. ALBRECHT. That's right.

Mr. ENGLISH. And you've decided the lawyers know more about trading and marketing, and know more about enforcement than those folks that are running those jobs, is that right?

Mr. ALBRECHT. I had the policy decision to make based upon all of the factors in front of me, including the advice of everybody that I talked to on the staff—which is a lot of people—including indirect discussions with my two colleagues here. The Commissioners are not really able to talk directly to each other because any two of us together is a quorum.

I am confident that these ideas were fully discussed, and vetted. If I pride myself on anything as the Acting Chairman of this Commission, I pride myself in the fact that I have brought more openness to the process in the Commission than was there previously.

I have included my two fellow Commissioners at the very early stages of every decision, I have encouraged the staff to make independent decisions, and I encouraged the staff, in fact, to write those memorandums if they disagreed with me because I wanted them to get these ideas out in public and have them debated.

I think that leads to much better decisionmaking, but one of the consequences of that is that you do have public disagreement about issues. I think that's healthy.

I take full responsibility for being part of that process.

Mr. ENGLISH. I think that's fine, but what you're going to have to take full responsibility for are the consequences of the acts, and this is going to be one that you're going to have to take the full consequences for.

Mr. Dial, you're in favor of opening up the door for fraud, I see. Can you tell me—explain to me how this is in the public interest?

Mr. DIAL. Mr. Chairman, I'm not in favor of opening the door for fraud.

Mr. ENGLISH. Well, that's what you've done.

Mr. DIAL. Mr. Chairman, my background is somewhat similar to yours, in that we both come from an environment of values where straight talk and tough enforcement are very important. The last thing that I would do, sir, is act to open the door to fraud.

Mr. ENGLISH. Mr. Dial, let me stop you right there, because there is no question, that's what you've done.

Whether you intended to or not, or whether you recognized and understood what you're doing or not, that's exactly what you've done, and as I said—and as your Director on Trading and Markets pointed out in her memo to the file—the Commission has never before exempted any transactions, subject to its jurisdiction in these areas, from these antifraud statutes.

Now, never before have you done that. I have never, quite frankly, heard of any other Federal agency—quite frankly, I consider this to be outrageous.

And talking about straight talk—I'm giving it to you. You want it, you're getting it. That's what it's all about.

And you say you're all for enforcement. Well, that's fine, but we have to have something to enforce first of all.

If we wipe the laws off the books, then you don't have to worry about enforcement, do you? Maybe that makes it a lot easier, but the fact of the matter is, your action opened up the door to fraud in this area.

Now there may be reasons—and I've heard, "Well, these are big boys. Let them take care of themselves."

I would suggest to you, before this thing is done, as a consequence of your actions, there are going to be some little people that are going to get hurt, too. They may be big in our part of the country, but they're little in this world, and it seems like, that any time when the big people get hurt, they have to fall someplace, and they fall on an awful lot of little people. The little folks end up bearing a good deal of this burden.

Now if you want to go out and take off on some economic theory—if you want to be a purist in economics and say, "By golly, we believe in the free markets. Let's open it up all the way," then I assume that you would be for wiping the fraud statutes off the books of the States as well, but as Ms. Bair pointed out, this statute has no more of a burden than do the State statutes.

This would have no more of an impact than what we find taking place in the States today, and—I just, quite frankly, have found the action to be outrageous.

Mr. Albrecht made the point that we had a comment period.

What did you say—you have a dozen people writing in or something like that?

We got into the swaps issue, and you were going to do the same thing on this, and I believe you got a call from me on that, didn't you?

Mr. ALBRECHT. I didn't, but I believe the Commission did, yes.

Mr. ENGLISH. Yes, they certainly did. And I made my views known. Did I get logged in as commenting—with regard to the matter of fraud?

I—didn't put it down?

Mr. ALBRECHT. I believe that——

Mr. ENGLISH. Members of Congress don't get their views recorded?

Mr. ALBRECHT. I was not in the Chairman's office at that time, and I don't know exactly how that happened. It may or may not have entered the official file.

It's my understanding that it came in fairly late, fairly well past the closing of the comment period, but in general, it's our policy that if a letter comes in, the letter will go in the comment file.

The phone call would not go into the comment file, because it's a phone call, it's not a letter. One wouldn't want to possibly misrepresent what a person——

Mr. ENGLISH. So because of the fact that I called the Chairman of the CFTC to express my—quite frankly, grave concerns—is the way I put it at that time—that the Commission was getting ready to act with regard to swaps, and you were going to exempt fraud in that area. You all were looking at doing it on swaps, too.

Mr. ALBRECHT. It was certainly under discussion.

Mr. ENGLISH. It certainly was. It was barreling down the track about 90 miles an hour.

I expressed some grave concerns about that, and then you decided, "Well, as long as it applies to futures, we'll go ahead and include it."

But swaps are not futures contracts in your view—are they, Mr. Albrecht?

Mr. ALBRECHT. I think that the——

Mr. ENGLISH. Is a swap a future?

Mr. ALBRECHT. I could say yes, I could say no. My main point is it doesn't matter.

Mr. ENGLISH. Well, either it is or it isn't.

Mr. ALBRECHT. It doesn't matter.

Mr. ENGLISH. I would disagree with you, because you all agreed to a ruling down there on this exemption with regard to swaps and the swaps fraud provisions, and I believe the manipulation provisions on swaps, and I believe the same thing is true with regard to this particular contract. It applies only as it does under the futures provisions of the law.

Is that right, Ms. Bair?

Ms. BAIR. Well, that's right. Congress did not require us to make a determination in advance that contracts that met the specific requirements of the exemption were or were not futures, but clearly, again, in my view, you cannot exempt something that's not within your jurisdiction, which is a futures contract.

Both the swaps rule and this rule, I believe, are sufficiently broad to include things we've traditionally viewed as futures contracts.

Mr. ENGLISH. But if you're viewing it the way Mr. Albrecht's counsel is—well, that's fine. We can go ahead and put that on the books because we don't view that as being a futures contract anyway; therefore, we have no regulatory authority anyway—right?

Ms. BAIR. If that's the analysis, we didn't need exemptive authority because, again, it would be——

Mr. ENGLISH. But am I correct in the way that—the trail that that follows?

Ms. BAIR. Yes. I agree.

Mr. ENGLISH. So if you're Mr. Albrecht, well, you don't recognize any of it—"It doesn't matter whether it's on the books or not because I choose not to view that to be a futures contract."

Is there any such thing, Mr. Albrecht, as a futures contract if it's not traded on an exchange? Does it have to be traded on an exchange to be a futures contract, or not?

Mr. ALBRECHT. I think that is a question that we no longer have to answer. The question is, if something has futures-like characteristics——

Mr. ENGLISH. I'm asking your personal point of view, Mr. Albrecht. You're the Chairman. You've been sitting down there on the Commission.

You're the ones that make the judgment call. I'm trying to figure out whether we have anything covered by fraud statutes. Maybe you don't view the stuff on the exchanges being futures anymore, for all I know.

Mr. ALBRECHT. I believe they are futures.

Mr. ENGLISH. So everything on an exchange is a futures contract, is that right?

Mr. ALBRECHT. If it's traded on a futures exchange, I believe it's a futures contract.

Mr. ENGLISH. Is there anything that's not traded on a futures exchange that is a futures contract?

Mr. ALBRECHT. There can be illegal off-exchange futures contracts.

Mr. ENGLISH. Do you know of any?

Mr. ALBRECHT. Not at the moment. We would have shut them down if we had.

Mr. ENGLISH. So therefore, if you haven't shut them down and they're not traded on the futures exchange by your very definition, they are not a futures contract.

Mr. ALBRECHT. Mr. Chairman, I do not think it is useful to spend a lot of time worrying about whether some of these instruments with futures-like characteristics are futures contracts. We have wasted an awful lot of time over the past 20 years doing that.

Mr. ENGLISH. Mr. Albrecht, let me just point out to you, it is up to this subcommittee and this committee and this Congress to make that decision, not you, and that's exactly what the problem is here today, Mr. Albrecht, because I think you have taken it on yourself to make these decisions.

You have taken it out of the hands of Congress, and as Commissioner Bair pointed out in her statement—and I assume, Commissioner Bair, you made that point to the other Commissioners—that in fact, you're going beyond what was the intent of the law, and certainly the intent of the exemption.

Mr. ALBRECHT. It was not my intent to do that. I believed, and I still believe that what I did was consistent with the law, consistent with the conference report, and I thought it was consistent with the intent of Congress.

Perhaps I'm mistaken, but I thought it was.

Mr. ENGLISH. You have a lot of folks that told you it wasn't, so—we'll take another round on this in just a little bit, but I'm sure Mr. Combest has a few questions.

Mr. COMBEST. Thank you, Mr. Chairman.

The whole issue of dealing in futures is an area which is not something that all of us have a personal awareness of. It is somewhat of a unique business, and given the fact that we're dealing with this in terms of legal questions—I'm not an attorney either—let me see if my understanding of the questions is correct. Please, make any changes in my scenario of what has happened here—any of you, that you would see—because I want to make sure that I'm understanding this correctly.

The question of jurisdiction in enforcing fraud provisions that were granted to the Commodity Futures Trading Commission had to do with whether or not the type of transaction fell within your jurisdiction. If the transaction did not fall under your jurisdiction, laws you are given to prevent fraud would not be applicable. As I believe, Mr. Dial mentioned in his testimony, there are statutes on the books to deal with fraud, if, in fact, fraud is found. On this question, your legal counsel, had differing opinions on the interpretiation and the intent of the Re-authorization Act as granted by Congress last year. You all considered the counsels' advice, you had a difference of opinion as to the type of transaction this particular thing was, and based upon what each of you viewed and looked at differently, you came to different conclusions.

Mr. ALBRECHT. If I could stop——

Mr. COMBEST. Please do.

Mr. ALBRECHT. I think that's true as far as it goes. I think that we all continue to struggle with this issue of how to interpret the exemptive authority.

Some people still use the futures/forward dichotomy and try to stick it into one of those. I, myself, view that as not terribly productive, and I've tried to view it in terms of, "Here's something we might have jurisdiction over. What's the appropriate sort of regulatory policy to follow?" But, I think we all agree that we could have come down differently on this, and the potential for different outcomes is substantial.

I do think that most of the transactions at issue are forward contracts. They're well beyond the reach of the Commodity Exchange Act.

It's possible that some of the contracts that are at issue here, under various readings of the Commodity Exchange Act, could be considered subject to our authority.

The question then is, should we exert our authority over those contracts?

I think there are two issues: One, what are these things? Then the other is, once we've somehow sorted through what they are, what we should do about them.

Mr. COMBEST. At that point, Commissioner Bair or Mr. Dial, do you have a comment.

Ms. BAIR. Yes. Again, I agree. I think this energy exemption is sufficiently broad to include things that are traditionally viewed as futures contracts. I also think it's sufficiently broad to be able to be misused by those who might want to set up fraudulent activities—boilerrooms targeted to small businesses—along the lines of what we've seen in the past.

Because we have not retained antifraud authority, we have removed our capability to prosecute those types of cases, should they occur. I think it's very easy to construct something that would fall within the parameters of the exemptive authority, and we just simply would not now have the antifraud—residual antifraud authority to do it—to go after these folks, so that's my concern.

My personal view as a policy matter—I think, whenever we're using 4(c) to grant exemptions to things that would otherwise fall within our jurisdiction, we should retain antifraud authority. I think it's just very basic and central to the Commodity Exchange Act.

The only exception I can see is, for instance, the hybrid area where you have either an SEC regulatory scheme or banking regulatory scheme with very extensive financial regulatory provisions against fraud that would apply to these instruments, so I think it was justified there, but otherwise, I don't think we should ever do it.

Mr. COMBEST. Mr. Dial.

Mr. DIAL. Yes.

Mr. COMBEST. You had some comments about my premise?

Mr. DIAL. Yes, sir. I agree with your premise, and once again, as I stated in my comments, I went to the language of FTPA and to the conferees report, the conferees did not "require any determination beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the act."

Also, the conferees allowed the status quo to be maintained with regard to the Brent interpretation.

Given those two factors, we—forwards are excluded from our jurisdiction.

In order for us to include the 4b antifraud provision in the energy exemptive order, we would have to have jurisdiction over these transactions.

My interpretation, and that of the legal counsel whose advice I sought, made it very clear that Congress recognized that we did not have jurisdiction over forwards, and these energy contracts are forwards, and therefore, we did not have the legal authority to include 4b in this exemptive order.

Mr. COMBEST. I can understand how people can look at the same information and obviously come to different conclusions. We do that every day here. We have the same information provided to us, and many of us come to many different conclusions.

Even though there was not—or would not be—the potential for the Commission to bring fraud charges if this exemption was granted, there would still be other means by which an individual who felt defrauded under this transaction could go through the legal system and claim fraud.

Mr. DIAL. Yes. Let me——

Mr. COMBEST. Commissioner Bair started to respond—excuse me.

Ms. BAIR. I would say—yes. The argument has been made that State antifraud laws—regular old common law antifraud provisions could apply to these transactions.

I think, though, you need to go back to the whole reason why the CFTC was created, and the SEC, and our whole Federal system of financial regulation, which was a recognition of the inadequacy of State remedies for these very complex, frequently cross-border, financial or fraudulent transactions.

I mean, if you carry that argument to its logical conclusion—again, you don't need a CFTC—even if there weren't a CFTC, if there were frauds being committed on exchanges, you could always go back and use State common law fraud, so I don't really see that that is an adequate basis for which—for us to give up our antifraud authority.

Mr. COMBEST. Yes. And I'm not trying to argue that you should. I would just——

Ms. BAIR. Yes. But, that is the——

Mr. COMBEST. Again, for my own perspective——

Ms. BAIR. That is the argument.

Mr. COMBEST. But let me carry that a step further. Generally, you would expect then—or it would be common practice that if someone felt defrauded, they would bring legal action under the fraud statutes given to the Commission or to another authority—be it SEC, CFTC, or whomever—that would be governing the exchange under which it was dealt?

Ms. BAIR. I think the question here is whether the CFTC can bring the action, not whether a private party can. And 4b applies to actions brought by the CFTC.

Mr. COMBEST. Right.

Ms. BAIR. And again, frequently you see—with these boilerroom operations—many people being ripped-off, with various levels of economic resources of sophistication to bring the action themselves.

Again, I think that's why you have a Federal agency taking the lead with the expertise and with the resources to close these kind of operations down.

Mr. COMBEST. Yes, sir? I didn't mean to cut you off. She just started to respond.

Mr. ALBRECHT. All right. Thank you. First of all, we should recognize the fact of what 4b is and what 4b isn't; 4b is designed to protect customers. It's designed to protect people who are being sold something by a broker, being defrauded by a floor trader, or something like that.

It is not designed to protect people in a principal-to-principal market. Most of these transactions we're talking about are beyond the reach of 4b, so to even say we're maintaining 4b—to say that does much would be illusory.

There's a lot of illusion that goes on about regulation, so I think it would be very foolish and dangerous, in fact, for us to say we're regulating a market when we do not have the authority to do that—when that regulation wouldn't do anything.

Now, I think we also must not lose sight of the fact that if people breach the terms of this exemption, they are subject to the Commodity Exchange Act. The type of activity that we've typically seen—boilerrooms—they're not covered by this exemption. That's illegal activity under the terms of this exemption, and we would try to stop it.

We have the authority to investigate all charges of boilerroom operation, and we have the authority to see if people are abiding by the term.

It's only people that abide by the terms of this exemption, which is for a principal-to-principal market—a commercial market—people that meet the various standards with appropriate "personhood" that are contained in this statute and our exemption, so I think we have to understand that—one, it doesn't—4b doesn't reach most of the transactions we're talking about here—the types of boilerrooms and illegal bucket shops, and so forth. Those are going to get caught up by us anyway.

Ms. BAIR. Could I please respond to that?

Mr. COMBEST. Yes.

Ms. BAIR. First, on the principal-to-principal argument, this is something I've heard before—that 4b won't apply to principal-to-principal transactions. We have brought cases—boilerrooms are typically set up as principal-to-principal transactions.

Mr. Klejna's memo, that the Chairman referenced earlier, addresses this point specifically, and says we have successfully prosecuted these types of cases where the scams are set up that way, and it has not become an issue before, and I don't think it should be. I think you want to have fraud applying to principal-to-principal transactions as much as you do to broker transactions.

Also, I cannot more vigorously disagree with the statement that we can still go after boilerrooms. That's the whole point. This is an exemption from our jurisdiction.

Even if our Enforcement Division could go in and prove that it's a futures contract—and would otherwise be subject to the CEA—if the promoter of whatever the fraudulent scam is has successfully constructed the fraudulent activity in a way that fits the parameters of this very broad exemption, we do not have jurisdiction anymore to go in and shut these things down.

Mr. COMBEST. So what you're saying is, that if a transaction was crafted in such a way as to create an exemption——

Ms. BAIR. If any—that's right. Any transaction that falls within the parameters of this exemption——

Mr. COMBEST. Yes.

Ms. BAIR. We do not have jurisdiction to prosecute.

Mr. COMBEST. Right.

Mr. Chairman, in the interest of other members, I'll wait for the next round. I have some more questions.

Mr. ENGLISH. Mr. Barlow.

Mr. BARLOW. Thank you, Mr. Chairman. I want to associate myself with the gentleman who has very serious concerns about boilerroom operations, and we need to stay on top of this situation for the sake of investors across the country, but let me just take a little bit different tact—and bear with me, I'm learning my way here.

We're talking about contracts here that are hybrid, swaps, derivatives—is derivative a generic name for this whole area in terms of a brokerage or a trader putting together a number of different types of vehicles—investment vehicles—and then selling them as one unit—this whole derivative area—are we talking about this?

Ms. BAIR. Well, derivatives is kind of a broad, generic term that can include anything, including regulated futures and options. I think what we're mainly focused on here are off-exchange derivative products that look like—if not, in fact, are—futures contracts, as those that have traditionally been defined by the courts, but to go under this specific order, we're talking about energy contracts.

Mr. BARLOW. Well, now is it possible that you could have a trader or a floor trader marrying in derivative oil futures, as well as wheat futures and corn futures and so forth, as one vehicle?

Ms. BAIR. Do you mean in boilerroom contracts—there would be——

Mr. BARLOW. I'm moving beyond the boilerroom. I have a concern with the whole way the derivatives process is developing in—not just our Nation, but in the world, with billions and tens of billions and trillions out there on the line, and I'm very sensitive to the fact that the regulatory authorities are trying to reach out to make sure there's not fraud, and just generally shoddy practices going on that can lead to—down the line—a disaster, and I'm very concerned from the standpoint of our jurisdiction about the grains, and even in the oil area.

We have in our area of the country, a river transport industry that carries a lot of crude, and I would not like to see a situation—an emergency situation blow up that involved the unraveling—because of fraud—of a number of contracts, and the oil is in the process of being transported by a barge line, and all of a sudden this barge line is in receivership because of fraud, so I would like to see the broad reach of fraud be kept.

I think everybody feels that we have an industry here that's exploding in all directions—hopefully, most of which is constructive, but if it's not policed properly, we can see fraud come up in agriculture to the extent that it's involved or wound into these derivative swaps in the futures area, and even the oil energy area can be severely impacted.

Does anybody want to respond to that in general terms? It's more a statement than a question, but—Mr. Albrecht?

Mr. ALBRECHT. I certainly agree that this is an industry or a market or a set of markets that's expanding dramatically in a variety of derivative products—products whose value is based on the value of some underlying products.

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An interest rate future is a derivative because its value is derived from the value of the interest rate. An oil future is a derivative because its value is derived from that, and they are increasingly complex. It's a very difficult task to put together the appropriate regulatory scheme for any of those. How much should we rely upon regulation, how much should we rely upon State law, regular Federal law, and how much should we rely upon private incentives.

All of us at the Commission, whether we agree or not on a particular outcome, are very much concerned about that, and are doing our level best to try to do what we can within the statute that we've been given. It's something we have been instructed to report to Congress on, and we will do so by the end of October of this year, and I'm sure it's something Congress will revisit from time to time, both in our area, and in many other areas.

Mr. BARLOW. So even though we're focused here on a particular law suit involving a Brent Oil contract, under these swaps and derivatives, other futures could be wound into a package here, and that might involve wheat futures or other things. It all depends upon the imagination of the trader, right?

Ms. BAIR. Could I just make one point of clarification?

Mr. BARLOW. Yes.

Ms. BAIR. This order—and this is a very important point, I think—this order is not confined to the Brent Oil market. This order is not confined to any particular identifiable energy market.

Mr. BARLOW. Right.

Ms. BAIR. This order extends to a broad range of energy transactions based on oil, natural gas, their derivatives, and condensates, so I think—to the extent your specific concern is with regard to off-exchange oil markets, you may very well have a concern with the Commission's failure to retain antifraud authority with regard to this energy exemptive authority.

Mr. BARLOW. Yes.

Ms. BAIR. It does encompass all those markets, not just Brent Oil.

Mr. BARLOW. Right. So oil—and to the extent that people are getting into derivatives that marry other futures contracts, a default in an oil contract could have repercussions into wheat and corn and so forth, no?

Mr. ALBRECHT. This exemption is limited to energy. I think we have to be very clear about that. There is no expansion of this particular exemption beyond the field of energy.

Now the Brent interpretation by contrast, while designed to deal specifically with the problem rising out of the *Transnor* case, is much broader than our exemption because it talks about delivery of physical commodities in general, and it is not specifically limited to oil, even though it was designed in response to a problem in the oil market.

Mr. BARLOW. Well, you might have a trader in oil who takes an extreme position in the oil futures market, and he's now outside the fraud provisions and he moves into unwise transactions—allegedly fraud—but he may lay off his exposure in the wheat market or the corn market or the cotton market or a number of other markets. If he defaults, it's going to have impacts there, right?

Mr. ALBRECHT. You really need more details, I think, to——

Ms. BAIR. This order does not apply to agricultural derivatives.

Mr. BARLOW. No. That's true, but if he defaults——

Ms. BAIR. Indirectly, there could be an impact.

Mr. BARLOW. If he defaults in the oil area because you've released him from surveillance, it will have impacts in these other areas, right? As those futures have to be unwound quickly or——

Ms. BAIR. I can't say that it wouldn't. I think, also, farmers and agricultural co-ops, to the extent—they are energy users and may have inventories of fuel on the premises. They could very well qualify as qualified participants for these exempt energy contracts, and be some of the small businesses that might be the victims of fraud in operations that would meet the requirements of this exemption, yes.

Mr. BARLOW. That's true.

Mr. DIAL. Congressman Barlow, if I might make an observation. At any point in time, that an instrument is a futures instrument or the transaction is one that is traded on a multilateral exchange facility, then it comes under our jurisdiction, so even though someone might design some derivative hybrid-type product that would involve energy and the ag commodities, or even a financial instrument once a futures transaction becomes a part of that, that aspect of that derivative product comes under our jurisdiction, and it is subject to 4b.

Mr. BARLOW. Even if energy's included?

Mr. DIAL. If it is outside of this exemption that we're talking about, and is futures, then it comes under our jurisdiction.

And as a point of clarification—in as much as I see the direction that your question is headed in—let me call to your attention, respectfully, that in this exemptive order it says, "And whereas this order is limited to commercial participants who, in connection with their business activities"—it lists several things—but No. 4 says, "Commercial participants who, in connection with their business activities, are not formed solely for the specific purpose of constituting an eligible entity pursuant to this order."

In other words, if someone forms a pool and they use that as a fraudulent vehicle, it does not come under this exemptive order, and we do have the opportunity to investigate that fraudulent, volatile conduct.

Ms. BAIR. I would have to register a disagreement with my colleague on that point. That particular provision applies only to entities that were solely formed for the specific purpose of qualifying as a participant for an exempt transaction, so I think commodity pools, FCM's, floor traders, floor brokers—if they have minimal participation in regulated futures markets, they haven't been formed solely for the purpose of qualifying to be a qualified participant for an exempt transaction.

Similarly, a boilerroom could simply have a partial interest in an oil well, and also fall outside the bounds of that requirement. I think, because of those qualifiers, it's a very limited use.

Mr. DIAL. But they also would have to meet all of the other requirements to be a qualified participant.

Mr. BARLOW. Yes.

Mr. Chairman, I'm just concerned that the farmers are being exposed here, and I'd like to see the fraudulent provisions kept as broad as possible.

Mr. ENGLISH. Thank you very much, Mr. Barlow.

Mr. Allard.

Mr. ALLARD. Thank you, Mr. Chairman. I was on the conference committee last year, and what I remember is that the committee wrestled a lot with the definition of these derivatives or swaps or hybrids or whatever, and there was some discussion about impact on international markets and how you define them and enforceability, and it seems to me like the results of a lot of that, as we decided at that conference committee, were that we set up a mechanism to monitor and gather information on how provisions of the bill worked in the form of a study, and determine if more regulation oversight is necessary.

Are you aware of any fraud, now going on, with these particular oil——

Mr. ALBRECHT. No. I'm aware of one case in a court in New York or Connecticut, in which a firm has been prosecuted for fraudulent arrangements with a bank. This was a firm that was in the market that has been taken care of by Federal authorities.

Mr. ALLARD. But it's been enforced, and as far as you know, as a result of your action here, you haven't—there hasn't been—and I guess there haven't as many times, but there hasn't been any——

Mr. ALBRECHT. There hasn't been any time——

Mr. ALLARD. Anything that's come up yet?

Mr. ALBRECHT. It still has not gone into effect yet.

Mr. ALLARD. So again, we're sort of back where we were in the conference committee, where some of the decisions that we maybe made in the legislation—we haven't had enough time yet to see how the enforcement is going to be applied and whether it's going to have a real impact or not, and one of the things that we wrestled with in the conference committee is that we can talk about boilerrooms, and all of us think in terms of a domestic company dealing with American citizens.

Then we get into the international market, and then how does that get applied with the international trade? I guess that's kind of where I'm thinking—we have businesses that deal internationally—at least, I can visualize that—for example, airline companies and fuel purchasers and whatnot.

In your opinion, how would we enforce—if we were to go ahead with what the chairman has suggested—how would we enforce that on a—or how would that interact with a foreign customer?

Mr. ALBRECHT. It gets difficult. We have, over the past few years, worked fairly close with authorities in other countries and we have established memorandums of understanding and so forth with them. We share information and we help one another in enforcement efforts.

Once fraud goes international, it becomes a little bit more difficult to catch and work with, but we continue to try to do that in all areas that are under our jurisdiction.

It's a resource-intensive effort. It takes a lot of time, it takes a lot of money, but we continue to do that.

Mr. ALLARD. We could have a foreign customer that could file suit in U.S. courts against a domestic company? Is that possible?

Mr. DIAL. Sure.

Ms. BAIR. We have that now.

Mr. ALBRECHT. Yes. That's the situation.

Mr. ALLARD. That's possible?

Mr. DIAL. Yes.

Mr. ALLARD. Is it possible for a domestic company to file suit against that foreign customer in U.S. courts? And if he's not a citizen of the United States, how would our laws apply to him?

Ms. BAIR. Well, if he's doing—I'm not an international law expert. I believe if he's doing business in the United States, though, that you usually can——

Mr. ALLARD. So what I'm wrestling with is how do we make United States law apply to foreigners who aren't citizens.

Ms. BAIR. Right. Could I back up just for a minute?

Mr. ALLARD. Yes.

Ms. BAIR. A couple of points, I think, need to be made. Again, this order is not confined to the Brent Oil market. This order is not confined to international markets.

This order applies to any "energy transaction which meets the requirements." That could be a completely domestic transaction.

Mr. ALLARD. Or it could be international.

Ms. BAIR. Or it could be international.

There are also, plenty of examples of fraudulent activity in boilerroom operations that come to our attention involving energy products, so I think that point needs to be made, too.

Also, I would reemphasize, as I did in my statement—my written testimony—the U.K. does—even in the international Brent Oil market, the U.K., which is frequently pointed to as a "good regulator," in terms of fostering international competitiveness of U.K. businesses—they have antifraud requirements that apply to the Brent Oil market.

Mr. ALBRECHT. Could I respond to that?

Mr. ALLARD. Yes.

Mr. ALBRECHT. Specifically, the question of the U.K. and its regulatory regime has come up, and I think it's worth talking about.

First of all, I think we all should understand that the U.K. system and the U.S. system are very different. No one would probably want to transplant their system here, and they wouldn't want to take ours.

In general, their system is a much less regulatory system than ours—a much lighter hand. To the extent there's a comparable agency to us and the SEC, it's the SIB. It has much less power than either the CFTC or the SEC. They rely much more heavily upon self-regulation than we do.

Now what Commissioner Bair is referring is the oil market code of conduct, which is put forth by the Securities and Investments Board. The Securities and Investments Board issues this code of conduct to publish information and give advice.

Among that advice, market participants are reminded that, "A market participant should not attempt to improperly mislead its counter-parties or dishonestly conceal material facts from them. Market participants are reminded that activity of this kind may amount to a criminal offense"—for example, under section 47.1 of the Financial Services Act. That means that the SIB would refer that to the appropriate national regulatory agency, much as we would do under our exemption if we found evidence of fraud.

We would refer it to the Department of Justice or the appropriate State authority, and I think we would probably say something more than "this may amount to a criminal offense."

This code goes on—"A market participant should not attempt to improperly manipulate the market. Activity of this kind may amount to an offense," and again, to be referred to another authority.

We would maintain manipulation authority within the CFTC under this exemption, so I think that a careful reading of the distinctions between the two countries makes it pretty clear that we haven't done anything particularly less-regulatory than in the U.K.

Mr. ALLARD. Ms. Bair.

Ms. BAIR. I would have to disagree with that. I think that, not only do antifraud provisions apply—it is true that the oil market code of conduct provides regulatory guidance, but section 47 of the Financial Services Act says that violations of the oil market code of conduct could be deemed to be in violation of the Financial Services Act.

The fact that the SIB—the enforcement structures such as the SIB must refer criminal actions to another enforcement body. It's just the way they are set up.

On the criminal side, we also have to—even things that we've retained jurisdiction over—we've had to refer to the Justice Department. We only had civil enforcement authority.

I would also add that not only do antifraud requirements apply under the oil market code of conduct and the Financial Services Act, but there are others that Brent Oil—15-day Brent Oil contracts are deemed investment contracts, which is the category that also includes futures under the U.K.'s financial regulatory scheme, and there were other requirements that—other regulations that apply, too, with regard to disclosure, capital requirements—even more than antifraud.

Mr. ALLARD. One thing I'd like to get back to, Ms. Bair, is, do you agree that if a boilerroom operation was reported to your agency, that could be referred to the Department of Justice and referred to the appropriate State authorities, and action could be taken against that operation?

Ms. BAIR. Well, it would depend on whether—since there's no—assuming that it falls within the terms of the exemption, there would be no violation of the Commodity Exchange Act, so we could refer it to the Justice Department if we could show—you'd have to show mail or water fraud, or you'd have to show State common law fraud.

Mr. ALLARD. But if that would get pointed out to the CFTC, that could be—I mean, there's no—I can't imagine just saying, "Well, we're just going to ignore it. It doesn't fall under our jurisdiction." If they would look for a suitable——

Ms. BAIR. I think, and I would hope we would do what we could by giving it to—bringing it to the attention of other enforcement bodies. I think the important point is, we are set up to prosecute those types of cases, and we couldn't do it now——

Mr. ALLARD. So it's a jurisdictional——

Ms. BAIR. Because we don't have jurisdiction anymore.

Mr. ALLARD. So it's a jurisdictional issue with you?

Ms. BAIR. It's a jurisdictional issue. It's a matter of whether we can fulfill our mandate to enforce the Commodity Exchange Act, including antifraud provisions, to the types of transactions where we traditionally have done so.

Mr. ALLARD. But what I've heard in testimony here is that the Department of Justice and State laws can go ahead and address the problem with the boilerrooms. It doesn't necessarily have to be the CFTC.

Ms. BAIR. Again, that is not what the Justice Department is set up to do. I don't know if we can get——

Mr. ALLARD. No. That's—I mean——

Ms. BAIR. Yes. I understand.

Mr. ALLARD. They can do that?

Ms. BAIR. Yes. They could do that.

Mr. ALLARD. So we're getting into sort of a jurisdictional perception. You'd like to see most of that power in CFTC, but if it's not there, it is in the Justice Department or it's also under State jurisdiction in some cases.

Ms. BAIR. I think that's a fundamental issue that this subcommittee, as our oversight subcommittee, needs to look at and deal with. Do you want a CFTC? Do you want us to enforce antifraud laws as they apply to these types of scam operations, the way we traditionally have done?

Mr. ALLARD. Yes.

Ms. BAIR. There is always mail and wire fraud that you can refer—you can try to plug that in and refer it to the Justice Department or State common law fraud, but in terms of enforcement bodies specifically set up to prosecute these types of fraudulent transactions, that's what I thought the CFTC was supposed to do.

Mr. ALLARD. Yes. You know, we were wrestling with this legislation, as to how you go ahead and define all these hybrid instruments and forwards and whatnots, and I don't want to disrupt the international market.

I want to see us go ahead, but on the other hand, we don't want to open the door for fraud or anything, and I think a lot of us are just waiting to see what's going to happen. I'd hate to see us jump prematurely if there isn't any actual problem going on.

Mr. Albrecht.

Mr. ALBRECHT. Let me just make a couple of points, if I may. One is that I think we have drawn this line in a responsible way. It's difficult, of course, to draw the line as to what you permit and what you don't permit. I don't think we're going to permit boilerrooms.

If things become full-fledged, run-of-the-mill boiler operations, such as Commissioner Bair is talking about, I am convinced they will run afoul of the exemption. I don't think you're going to find those under the exemption.

If it turns out that I'm wrong, it would be very easy for the Commission to address this issue—to revisit it, and change those lines.

What we have tried to do is draw a line around this market, which permits the existing market to continue to exist. We tried to draw a line around the market, such that it will not permit the type of boilerroom operations that Commissioner Bair is talking about to exist.

In truth, those two lines are probably not exactly the same line. Whatever line you draw will probably exclude a few people from the market whom you would like in the market. It also has the potential of letting some activity go on that you prefer not.

I think we've examined this issue very carefully, and drawn the line in a very responsible way. If, as you point out, experience proves us wrong, we may want to expand that line, and we may want to contract it.

Mr. DIAL. I'd also like to make an observation in that regard. In the first place, once again, in my opinion, what we're talking about are forwards, and forwards have a history of nearly a century of being used in commerce—domestic commerce and international commerce.

Those that commented on this particular proposal did not make any mention of problems with fraud, either in today's markets or in markets that are past, so there is no strong evidence to indicate that fraud is rampant in these energy contracts.

In addition to that, in enacting the 1992 act, Congress explicitly authorized exemptions from all provisions of the act, except section 2(a)(1)(b), and simultaneously enacted a conforming amendment to section 12(e)(2), explicitly acknowledging that State antifraud statutes of general applicability would continue to apply to exempted transactions, so——

Mr. ALLARD. Mr. Chairman, I'm ready to wind up, if I could just have one more question with Ms. Bair.

You had replied to one of the chairman's questions that the law can apply when they're exempted. Did I understand that——

Ms. BAIR. Under the terms of this——

Mr. ALLARD. Our understanding is correct. Then on your testimony—you see, in your written testimony, you said, "Let me state that I do not oppose in concept, some type of exemption from the act from the Brent's crude oil contracts," which just all seems to center around that, and it almost sounded to me like there was sort of a contradiction here in the way you are responding in this, and if you'd highlight that and——

Ms. BAIR. No. I was referring to——

Mr. ALLARD. Talk a little more.

Ms. BAIR. I also go on to say, "But I think we should retain antifraud and antimanipulation authority." Yes, I support an exemption from virtually—for the Brent Oil market for virtually all other regulatory requirements of the Commodity Exchange Act.

And 4b, the general antifraud provision, and 4o, our antifraud provision that applies to commodity pools, I think are very fundamental and basic, and we should not have banned an exemption there.

Mr. ALLARD. So we can take——

Ms. BAIR. We have in this order.

Mr. ALLARD. All right.

Ms. BAIR. And again, this order is not limited to the Brent Oil market. It is much, broader than that.

Mr. ALLARD. Thank you.

Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you very much, Mr. Allard.

I also want to make a point. This, Commissioner Bair, if I'm not mistaken, does, as you point out, goes beyond the *Brent Oil* decision.

Ms. BAIR. Absolutely.

Mr. ENGLISH. And this expands on the authority that existed prior to the enactment of the reauthorization bill last year.

Ms. BAIR. I think, to the extent that the intent behind that was for us to use exemptive authority only to address the issues pertaining to existing markets, yes. I think it goes beyond that.

With regard to—I know Chairman Albrecht may have a different view—I think this order is much broader than the Brent Oil statutory interp. I would note that the people who applied—the energy group that applied for exemptive relief said in their application that they need broader guidance, more comprehensive guidance in meetings held with Commission staff—notes of which you have.

Again, they said it's not enough to just have the Brent statutory interp. We need more relief that applies to a broader range of energy markets. There is no doubt in my mind that this order is significantly broader than the Brent Oil statutory interp.

Mr. ENGLISH. And certainly goes way beyond the status quo understanding that was reached between the members of the conference last year.

Ms. BAIR. Again, I was not privy to that. I can only go by what was in the conference report.

My interpretation of the conference report was that—yes, you wanted us to use this authority very judiciously and stick—yes, provide additional clarification with regard to existing markets where issues have arisen.

I think, clearly, with regard to the Brent Oil market, that is the case, and it would have been appropriate and consistent with your legislative intent, as I understood it—give relief to Brent Oil—but we went beyond that.

Mr. ENGLISH. As Mr. Allard pointed out, he was a member of the conference, and if you recall last year, that was the understanding that we reached—that there would not be—we would maintain the status quo, and that was exactly what the purpose of these provisions we put in the law were for.

Mr. ALLARD. Yes. Mr. Chairman, did Mr. Albrecht say that actually—your decision continued the status quo?

Mr. ENGLISH. Well, he may say it, but that isn't what it does. That's the whole point.

Mr. ALLARD. So there's a difference of agreement whether we continued with status quo or——

Mr. ENGLISH. No. There isn't a difference of agreement at all. I don't think you're going to find any lawyer that isn't sitting on that Commission that's going to give you that opinion.

If I could continue on this—Mr. Albrecht, you also made the statement that—with regard to the terms of the exemption—the terms of the exemption that are granted to anyone who falls under that category—if someone commits fraud, they are not violating the terms of the exemption, are they?

Mr. ALBRECHT. Not by that act.

Mr. ENGLISH. So the exemption that you have granted—a person could go out and go so far as committing fraud, and they would not be violating any terms of the exemption granted by the CFTC, and the action of committing fraud would not be sufficient to have that exemption revoked.

Mr. ALBRECHT. I think that if we found fraud——

Mr. ENGLISH. I'm just asking you, under the terms of the exemption. Under the terms of the exemption——

Mr. ALBRECHT. Under the terms of the exemption, a person could defraud a bank, defraud a customer, could lie to Congress, lie to the CFTC—that would not violate the terms of the exemption. It would violate other things, but it wouldn't violate the terms of the exemption.

Mr. ENGLISH. Also, I was curious—under the terms of the exemption, we also have broker dealers and, of course, futures commissions merchants that are subject to the antifraud provisions of the law on traditional futures contracts. Why is there a different treatment in this area? Why shouldn't antifraud apply to broker dealers and futures commission merchants who are in this area, as opposed to those who are dealing with the traditional futures contracts?

Mr. ALBRECHT. It would apply, of course, to their activities dealing with customers in traditional futures contracts.

I've tried to get this in a couple of times, and I think it would help if I could do it sooner rather than later because——

Mr. ENGLISH. I'd like for you—if you would answer my question, please. The question I asked you is, why is there a different application to broker dealers and futures commission merchants under traditional futures contracts, as opposed to under these contracts?

Mr. ALBRECHT. For the very reasons that we gave the exemption. This is a commercial-to-commercial market. It's a principals market.

It's not the general public. It's a fairly closed group of a fairly small number of people that know each other——

Mr. ENGLISH. How do you know that?

Mr. ALBRECHT. Know the credit worthiness of one another, and there's no reason to subject somebody to a particular law, just because he happens to be an FCM, for that particular type of transaction.

If it spilled over in any way to their regulated activity, it would be subject to our law. In any event, we still have the authority to use our risk assessment to determine whether there were any financial integrity issues raised by this activity. They still have that authority.

Mr. ENGLISH. Now as I understand it, the CFTC supposedly still has a study underway to determine exactly what we're talking about in the derivative markets, and what is involved in the derivative markets, and every bit of testimony we've received—every indication we've received from people who have been involved in this, particularly within the General Accounting Office—no one knows for sure, so I'm intrigued, Mr. Albrecht, with the finding that you have.

This is a fairly small group of people, all of whom know each other, all of whom are financially—I don't know what that means—what was the term you used? Financially secure? Financially well off? What does that mean?

Mr. ALBRECHT. I'm not—that's not in the order I used it. I used it rather imprecisely. We have specific net worth and asset tests and so forth in the exemption.

Mr. ENGLISH. But how do you know that?

Mr. ALBRECHT. Well, of course, one doesn't know exactly in every transaction——

Mr. ENGLISH. So you, with regard to the individuals that will be involved in this market—and as Commissioner Bair pointed out, this is not just the Brent Oil folks, this is an energy exemption—and you're telling me that you personally know who all these individuals are, you personally are aware of the transactions that they carry out, and personally aware of their financial situation, and you know that this is not going to have an impact on the public, is that right?

Mr. ALBRECHT. Well, of course, I don't know that.

Mr. ENGLISH. Well then, why did you make that statement?

Mr. ALBRECHT. I don't believe that I said that I know these people.

Mr. ENGLISH. Well, who does?

Mr. ALBRECHT. First of all, if they do not meet these standards, they have violated the terms of the exemption and they are subject to our oversight.

Mr. ENGLISH. Who is carrying out the investigation as to whether or not they've met the terms of the exemption?

Mr. ALBRECHT. Somebody would have to complain to us, and we would carry out the investigation. We would have to have people carry out the investigation——

Mr. ENGLISH. Only after the fact, do you determine whether or not someone was truly eligible under whatever it is you have in your mind—the criteria the people should have to meet this exemption?

It's an after-the-fact determination as to whether or not they were exempt, but before that fact, unless someone brings it to your attention, unless someone complains, unless there is some reason, which I suppose would have to be a complaint for an investigation by the CFTC, and there would have to be a finding, I suppose, before you carried out that investigation, then you have no idea who's getting this exemption, you have no knowledge with regard to their financial circumstances, and you know absolutely nothing about the people that are being covered by a blanket exemption, which takes on, quite frankly, the characteristics of an exclusion rather than an exemption.

Mr. ALBRECHT. The fact of the matter is that—one, virtually every time fraud occurs, we find out about it after it has occurred, and we go in and investigate if we have a complaint——

Mr. ENGLISH. Well, Mr.——

Mr. ALBRECHT. May I please finish?

Mr. ENGLISH. Well, the thing that troubles me is you're not answering my question.

The question I asked you, Mr. Albrecht, is how you responded to my question, with regard to the differences as to why someone who is a broker/dealer or a futures commission merchant should be required to be under that act if they're trading under traditional futures contracts—but in this case, they should not.

What I was looking for was the justification as to what is the justification for making this difference between the two under—and granting one an exemption, and not the other, and you responded by saying, "This is a very small number of people. These are people who are well-known with each other. They're financially secure people."

Then I asked you, "Well, then do you personally know them?" You said you do not know them personally.

Then I tried to determine—"Well, what is"—what do you know about them, and evidently you don't know anything about them, so you don't know whether it's a small group of people, a big group of people—you don't know whether they're broke on their tail today, but you've granted the exemption under the illusion, I suppose, that these are the kind of folks that deal in this market—because somebody told you so.

Is that all you know about it? Is that right, Mr. Albrecht? Is that the only knowledge that you have—it's because somebody told you that's the way it was?

Mr. ALBRECHT. We have representations in the applications about the nature of this market. We have reason to believe those representations are accurate.

Mr. ENGLISH. Well, who are these people? That's what I'm trying to find out. How do you determine the credibility of these people?

Mr. ALBRECHT. I think they're listed in the energy exemption. The names are there.

The big oil companies, the big gasoline companies are the major people that——

Mr. ENGLISH. Are they the only ones trading in this area?

Mr. ALBRECHT. They are the major people that are in this market today.

Mr. ENGLISH. How do you know that?

Mr. ALBRECHT. I have been told that.

Mr. ENGLISH. Who told you that?

Mr. ALBRECHT. We were told that in comment letters, we were told that in——

Mr. ENGLISH. You got 12 comment letters, I believe you said.

Mr. ALBRECHT. We were told that in comment letters, we were told that by the people that applied for the exemption.

Mr. ENGLISH. So the people who want to be exempt are the people who have given you the information that you're relying on to base this decision before they're ever exempt. Is that right?

Mr. ALBRECHT. And as I've indicated, if people do not adhere to the terms of the exemption, then they are subject to our jurisdiction.

Mr. ENGLISH. So they can go out and commit fraud, and not violate the terms of the exemption, they can—as long as they don't get caught, they can continue the exemption.

What are the terms of the exemption? In what possible way could they violate the terms of the exemption?

Mr. ALBRECHT. If a firm does not meet the standards set forth in that exemption——

Mr. ENGLISH. What are the standards?

Mr. ALBRECHT. The standards are: They have to be commercials, they have to be involved in the business in one way or another, they have to assume risk other than price risk— they have to meet one of the various standards of being an appropriate person.

Mr. ENGLISH. An appropriate person?

Mr. ALBRECHT. Appropriate person. That's the language that I believe is in the legislation.

Mr. ENGLISH. So as long as they meet that general criteria—how in the world could they violate that criteria? I mean, how could they not be exempt? That's a better question.

Mr. ALBRECHT. If you were in that market, you would violate it. I don't think you're in the terms of the—perhaps I don't——

Mr. ENGLISH. I don't know that I would, because you'd have to catch me first, Mr. Albrecht, and I don't know that you can catch me.

Tell me about the detection system that you have set up to go in and identify those people who are violating the agreement. What kind of detection system does the CFTC have set up to determine whether or not someone is, in fact, violating the agreement?

Mr. ALBRECHT. We would have to get complaints.

Mr. ENGLISH. You'd have to get what?

Mr. ALBRECHT. Complaints.

Mr. ENGLISH. So if nobody complains, it's a blind eye from the CFTC—"You guys go do whatever you want to. Commit fraud, do anything you want to, just don't tell us about it"—is that right?

Mr. ALBRECHT. That's the way we catch all fraud—almost all off-exchange fraud. We have monitoring systems on exchanges. We don't have monitoring systems elsewhere.

Mr. ENGLISH. But in this case——

Mr. ALBRECHT. We have 570 people——

Mr. ENGLISH. In this case, Mr. Albrecht, there's a difference. In the other cases you're mentioning, we have laws, we have rules, we have statutes, and we have a regulatory body that has the responsibility to deal with that.

In this case, you've exempted them. If they're exempt, they're exempt. If you get complaints of fraud, you've exempted them from fraud.

How in the world can you take any action against someone you have exempted from fraud? They can go out and just cheat people blind, and there's not a blooming thing you can do about it.

The very agency that we have put our trust into—if you can't deal with fraud, Mr. Albrecht, there is no reason for you to be here.

Mr. ALBRECHT. We deal with—we would——

Mr. ENGLISH. By the way, when does your term expire, Mr. Albrecht?

Mr. ALBRECHT. It has expired.

Mr. ENGLISH. It has? So you're a lameduck.

Mr. ALBRECHT. I'm very lame.

Mr. ENGLISH. And this was a lameduck decision.

Mr. ALBRECHT. This was not a lameduck decision. I guess it would have been easier to duck this decision, but I made it because I thought we needed to keep moving.

Markets don't wait for Presidents to make appointments. Markets continue to move. We needed to do something.

If I could just say——

Mr. ENGLISH. Well, let me just say, I wish to God you had. I think the public—this country would have been better off if you had.

Mr. ALBRECHT. We regulate this the same way we regulate fraud in forward markets. We have no jurisdiction over forward markets. The only way we would find out if the law was being violated is if somebody were to tell us, "Hey, this isn't really a forward market," then we would take a look at it.

Mr. ENGLISH. But in this particular case, you've been handed special authority by the Congress—special authority to maintain the status quo until the Congress can make a decision—until we can make a judgment as to how to deal with these kinds of instruments with the derivatives—only to maintain the status quo, not to produce an end.

But you saw fit to take that responsibility beyond the status quo, and now you tell us that you have no way of determining whether or not the criteria that you have set out to qualify for the exemption is even being met, isn't that right?

Mr. ALBRECHT. I'm sorry. The question specifically is?

Mr. ENGLISH. The question is specifically, you have no way of determining whether or not the criteria that you have set out under the very special authority that has been granted by the Congress to deal with some very special problems—you have no way of determining whether or not that criteria is being met.

You cannot assure the public, you cannot assure the Congress, you cannot assure this Nation that, in fact, the criteria that you have set out for this exemption from fraud is being met.

Mr. ALBRECHT. We can tell, anytime we look at a situation, as to whether it is being met, so we do have a way.

Mr. ENGLISH. How can you do that?

Mr. ALBRECHT. We look at the participants, and we see if they meet the criteria——

Mr. ENGLISH. You don't even know who they are, Mr. Albrecht. We don't know who they are.

Mr. ALBRECHT. If we had a situation to look at, we could do that—we would do that. We would look at this market and say, "Who are the participants? What are they doing?"

Anytime we want, we can go in and look at a market—of course, we can do that.

Mr. ENGLISH. You have——

Mr. ALBRECHT. We would if we had any reason to believe that we should.

Mr. ENGLISH. If you had any reason to believe that you should.

Mr. ALBRECHT. Which is much the way we conduct all of our investigations right now.

Mr. ENGLISH. You have no way of knowing—when you grant that exemption, you're not granting it to individuals, you're blanket-exempting. Anyone and everyone who's involved in this business is exempt from fraud.

Isn't that what it says?

Mr. ALBRECHT. I don't believe that's what it says at all.

Mr. ENGLISH. Commissioner Bair, is that your interpretation?

Ms. BAIR. Again, my interpretation of the exemptive order is, if it meets the terms of the exemption, yes. It's completely off our——

Mr. ENGLISH. And we'd have no way of knowing what the terms of the—whether they're meeting the terms of the exemption or not, do we?

Ms. BAIR. I think that's a good point. I think—and I believe that was specifically referenced in the legislation—that perhaps there should be some monitoring system to determine—not only just this area, but swaps and hybrids as well—whether the terms of the exemption are being met. That is not in existence now, that I know of.

Mr. ENGLISH. So under the ruling by the Commission—Mr. Albrecht and Mr. Dial—they have decided that we shouldn't do that. They've made the decision under this ruling that we will have no check whatsoever to determine whether or not the individuals, who are being exempted, meet the criteria under the exemption.

We have no way of determining whether or not the people that we are providing this trust are the biggest thieves in the world—maybe some of the biggest thieves in the world—and we're turning them loose—loose from all fraud requirements of the CFTC—of the very regulatory body that is supposed to be looking out for the public. Is that correct, Commissioner Bair?

Ms. BAIR. I don't want to speak for my colleagues, but that is——

Mr. ENGLISH. I'm just asking your opinion.

Ms. BAIR. Yes. In my opinion, that is what has happened—that it is a very broad exemption, and if folks—whoever wants to—has the creative mind to do it, can meet the terms of the exemptions. I think it's very easy to do.

They are exempt from everything, including our antifraud requirements, and we can't do anything about it.

Mr. ENGLISH. Let me go back then, Mr. Albrecht. Do you have any way of identifying who the individuals are that you're granting this exemption to?

Mr. ALBRECHT. We know who some of them are. We don't know who all of them are.

Mr. ENGLISH. Can you even say you know who most of them are?

Mr. ALBRECHT. Personally, no.

Mr. ENGLISH. Does the CFTC know who most of them are?

Mr. ALBRECHT. Probably not.

Mr. ENGLISH. So you don't know who the individuals are that we're granting the exemption to. Let me take the next step then—do you have any mechanism, as was recommended in the legislation—do you have any mechanism to determine and see if, in fact, the people who are receiving these exemptions meet the criteria?

Mr. ALBRECHT. We have two mechanisms. One is that——

Mr. ENGLISH. I'm talking about before the exemption is granted.

Mr. ALBRECHT. Well, the primary mechanism, of course, is to respond to allegations that something wrong is going on. I would expect that the Commission would continue to keep an eye on this market—to revisit it, to look at it, to make sure the terms of the exemption are being met.

Mr. ENGLISH. Is there any mechanism that you have set up in this ruling to do that?

Mr. ALBRECHT. We have not done that.

Mr. ENGLISH. So there is no assurance to the public that that criteria is being checked. It's not being checked before the exemption's given. There's no mechanism in the criteria to check it afterwards.

The only thing that the public can hope for is that if we have any people who are committing fraud, that those people—somebody blows the whistle on them at some time. That's the best we can hope for.

Mr. ALBRECHT. That will happen.

Mr. ENGLISH. That will happen?

Mr. ALBRECHT. If there is any serious amount of fraud, people will blow the whistle.

Mr. ENGLISH. If there is any serious amount of fraud.

Mr. ALBRECHT. There can be an isolated instance where someone gets cheated out of a nickel or a dime, but I mean, if there is——

Mr. ENGLISH. Well, we're talking about billions and billions of dollars being traded here, Mr. Albrecht. We're not talking about nickels and dimes, we're talking about billions on international markets that, according to the president of the Federal Reserve in New York, can have an impact on the very economy of this country. Isn't that correct?

Mr. ALBRECHT. If there's any fraud of any significance, it will be found out about. The person who is defrauded will complain.

Mr. ENGLISH. Mr. Albrecht, I'm going to tell you, that's a very naive way of thinking. We have crimes committed in this country that are not reported.

We have a lot of crime, and a lot of people that are victims of crime that are not reported, and it may go on for some time before it's reported, much less the individuals being caught.

If you're simply assuming that every crime that is committed is going to be reported to the CFTC, I think you have a very naive view of the world. It doesn't happen that way in real life.

If you aren't aggressively—if that is the case, why in the world do we bother to have people looking at the futures exchanges? Why don't we just sit back and say, "Well, if there's a problem someplace, somebody will give us a call"—why did we bother to have the FBI, and of course, that raises the question—maybe we now are seeing it—why it took the FBI and the U.S. Attorney in Chicago to put undercover people in place.

It brings us down to the real question of "What in God's name is the CFTC all about?" If it's not—if we can't even count on the CFTC to protect the public from fraud, if we can't depend on the CFTC not to give away the store, from the standpoint of giving blanket—not exemptions, exclusions—that's an outrage. I mean, you're not worth your salt if you can't do that, Mr. Albrecht.

I have defended the CFTC for the last 4 years. I fought for increasing the budgets of the CFTC for the past 4 years. I've fought to prevent incursions on the jurisdiction of the CFTC for the last 4 years, but I have to tell you, today I'm asking myself, "Why, in God's name, did I do it?"

I think your actions have raised serious questions as to whether or not the CFTC can be entrusted with this responsibility. I can certainly agree and understand differences of opinion, but when it comes down to opening the door to fraud, that's simply going too far. That's not deregulation, that's just blatant irresponsibility.

I would encourage the Commissioners to reconsider their decision in this area. I would encourage the CFTC to consider, any time they're granting any exemption, a provision in which any crimes of fraud or manipulation—that that be applied in general and not just under the specific futures provisions of the CFTC—that the CFTC retain the right, regardless of whether on any responsibility that they might have, regardless of whether it is or is not defined a futures contract, to act in dealing with fraud and manipulation.

I would encourage the CFTC to look at private rights of action. If you want somebody to come tell you about fraud, that's the way to do it, Mr. Albrecht—give them that right—give them some kind of recourse.

And to simply dump it back and assume that the States are going to be able to handle this is just an outrage, when you've taken away part of the authority that the States have had.

I have to say, in the 18 years that I've been in Congress, this is the most irresponsible decision I've come across.

Mr. Allard, do you have any other statements or comments you'd like to make?

Mr. ALLARD. No, Mr. Chairman.

Mr. ENGLISH. I said, I urge the Commission to reconsider this decision.

With that, we'll recess, subject to the call of the Chair.

[Whereupon, at 12:10 p.m., the subcommittee adjourned, to reconvene, subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

Statement of Dr. William P. Albrecht
Acting Chairman
Commodity Futures Trading Commission
Before the Subcommittee on Conservation, Credit
and Rural Development of the
House Committee on Agriculture
April 28, 1993

Good Morning, Mr. Chairman and members of the Committee. Six months ago today, the President signed into law the Futures Trading Practices Act of 1992 ("1992 Act"). Since then the Commission has been working diligently to implement the statutory reforms and new authorities which you and this Committee helped originate. For your information, I have attached a summary of actions the Commission has taken in response to the 1992 Act.

Today, I welcome this opportunity to discuss one of our most recent steps: exempting from regulation under the Commodity Exchange Act ("CEA") certain contracts for the deferred purchase or sale of specified energy products.

Statutory Background

Prior to the 1992 Act, any instrument classified as a futures contract could lawfully trade only on a CFTC-designated exchange. Other instruments such as forward contracts were completely excluded from CFTC authority. This all or nothing approach worked fairly well for more than fifty years. However in recent years we saw the advent of new financial and commodity products which contain both futures and non-futures elements. Clearly, the financial and commodity markets were evolving in ways never contemplated when the CEA was originally drafted. The Commission found itself spending more and more time studying these new off-exchange instruments, trying to fit them into the right statutory pigeon hole. The CEA's inflexible requirements also impeded the introduction of economically useful new products which might fall on the futures side of the line, but were not suited for exchange trading because of contract size, limited interest or other factors.

After studying these issues, Congress wisely recognized the need to give the Commission greater flexibility in dealing with innovative products. Thus, the 1992 Act added Section 4(c) to the CEA. This provision gave the CFTC authority to exempt any agreement from the exchange-trading and most other requirements of the CEA contingent upon certain conditions. Those conditions include: a Commission determination that the exemption is in the public interest; the agreement is between appropriate persons (such as institutional participants); and the agreement does not have a material adverse effect on the ability of the Commission or any exchange to discharge its regulatory or self-regulatory duties. The Conference Committee explained that the Commission was granted this exemptive authority in order to provide "certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner." The Conferees specifically stated that they "expect and strongly encourage the Commission to use its new exemptive powers promptly upon enactment [of the 1992 Act] in four areas where significant legal uncertainty have arisen...." These areas included swaps and hybrids, where the Commission acted in January, and forwards, which are the subject of the Commission's recent energy contract exemption.

The Energy Contracts

The classification of energy transactions as futures or forwards had become a crucial issue in 1990, when one court found certain transactions in the Brent crude oil market to be futures contracts. See Transnor (Bermuda) Limited v. BP North America Petroleum, 738 F. Supp. 1472 (S.D.N.Y.). These transactions had never before been considered futures contracts. Now, they could be void as off-exchange futures contracts. This decision stunned the international energy markets. Technically, this aspect of the case applied only to Brent market transactions. However, the facts in Transnor involved individuals, firms and transactions on four continents and the language of the decision brought into question trading practices throughout the international and domestic energy markets. Clearly, the sophisticated international energy and trading firms that made up this market should not be permitted to walk away from losing transactions by simply declaring their contracts void as off-exchange futures contracts.

The Commission's response was to issue a statutory interpretation stating that it did not view these transactions as futures, but rather as cash forward contracts, and thus excluded from regulation under the CEA. Unfortunately, this action did not completely resolve the problem. Legal uncertainty continued and was reportedly sufficient to deter some international firms from entering into transactions with U.S. firms.

Congress was aware of this and specifically mentioned the Transnor case in the Conference Report on the 1992 Act. The Conferees encouraged the Commission to review the situation to determine whether exemptive or other action should be taken. The Conferees noted the international scope of these markets and also that, since foreign participants were free of restraints imposed by the CEA, competitive disadvantages for the U.S. could result.

Commission Response

Last November -- just three weeks after the 1992 Act became law -- the Commission received an application for exemptive relief for these contracts. In January, in response to this application, we published a proposal to exempt certain contracts for the deferred purchase or sale of specified energy products from Commission jurisdiction. The Commission limited its proposal to existing practices in the energy markets, as described in the application. Since the Commission was not regulating this market, the proposal essentially maintained our existing jurisdiction.

The Commission received sixteen comments on the proposal, all but one of the which generally supported the proposed exemption. After carefully considering the views of the commenters, the

Commission granted the exemption, limiting its order to those general types of commercial participants identified in the application. The Commission made some technical changes in the final exemption, such as including "condensates" as an underlying commodity, and tightened the exemption to eliminate provisions that would have allowed qualifying firms to act as fiduciaries on behalf of customers. Beyond that, the exemption was largely adopted as originally proposed.

I believe the Commission made the right decision. The exemption covers large commercial participants in off-exchange, energy based transactions. These transactions compose a large ongoing market for energy products -- a market that is vitally important to U.S. and international commerce -- that has existed for many years, continually growing in size, importance and complexity. The Commission has never regulated nor sought to regulate this market. I am aware of no reason sufficient to justify Commission regulation now. Indeed, this market, its transactions and participants are clearly within the scope Congress intended for the exercise of the Commission's new exemptive authority.

Section 4b of the CEA

Questions have arisen, however, as to whether the Commission should have reserved the applicability of the anti-fraud provisions of section 4b of the CEA in granting this exemption. We specifically requested comment on this issue in the Notice of

Proposed Rulemaking. No commenter advanced any arguments supporting Commission retention of anti-fraud jurisdiction and most of the commenters affirmatively opposed it. They cited the commercial nature of these transactions and the fact that the proposal was limited to commercial participants and other "appropriate persons" -- sophisticated entities quite able to look out for their own interests. A majority of the Commission agreed. They voted not to retain Section 4b to whatever extent it might apply to these transactions.

Some have urged that the Commission should have retained section 4b, as it did in the case of its swaps exemption. Indeed, I have even heard it said that the Commission cannot legally exempt these energy contracts from section 4b. While one may reasonably disagree with the merits of our decision, as a matter of law the exemption is clearly within the CFTC's statutory authority: the exemptive power runs to <u>all</u> provisions of the CEA with the sole exception of section 2(a)(1)(B).

As a matter of policy, I fully support the decision not to apply 4b to these exempt energy transactions. One of the most valuable aspects of our exemptive authority is that it allows the Commission to proceed on a case-by-case basis -- an exemption for one product can retain some regulatory controls while another exemption can retain more, or none at all.

In the case of swaps, for example, the Commission did agree to reserve section 4b, as suggested by several of the commenters on that proposal. I think that too was the right decision. Section

4b covers fraud committed by one person acting for or on behalf of another: an agent acting for its principal, if you will. The swaps exemption specifically permits some eligible participants to act on behalf of other eligible participants in entering into swaps transactions. Thus, the principal-agent aspect of section 4b could have relevance if a given swap agreement was found to be a futures contract.

This is not the case with the energy exemption. These energy contracts are entered into between principals. The exemption applies only to "bilateral contracts between two parties acting as principals", thus it does not allow one participant in this market to act for or on behalf of another. Accordingly, any relevance of section 4b on its face to these transactions is highly questionable.

Furthermore, in the Commission's 1990 statutory interpretation, we took the position that generally these were not futures contracts, but rather forward contracts. By law, section 4b does not cover forward contracts. Thus, any attempt to actually take an enforcement action based on 4b would face substantial jurisdictional hurdles.

In these circumstances, rather than providing a potential benefit, retaining section 4b would create legal uncertainty. Having gone to great lengths to assure foreign energy firms that they may engage in normal pre-Transnor business practices with U.S. firms, the presence of 4b may say to some that the futures issue is not over. To some of these firms the presence of 4b would indicate that the CFTC is exerting some jurisdiction over them and that more may follow. Further, it would inject the illusion of Commission supervision into a market where there is none. In that regard, some may take comfort from the coverage of 4b, but it would be cold comfort indeed without the benefits of any ongoing regulation. After all, the Commission just does not have the resources necessary to adequately regulate these markets. In short, the benefits of extending the coverage of 4b to this market are not apparent.

While it is correct that the Commission has exempted these transactions from Commission regulation generally, and in particular from Section 4b of the CEA, that does not mean that these transactions are above the law, or that fraud is somehow permitted. While problems can occur, as evidenced by Transnor's refusal to pay and take delivery of Brent oil, these are generally private contractual disputes that typically do not involve public concern about fraud or market integrity. To the extent there are concerns about the ability of these firms to perform their contractual obligations, these large commercial institutions do not appear to need or desire the assistance of the Commission to police their market to assure performance of contractual obligations. Nevertheless, to the extent this activity occurs in firms related to a futures commission merchant ("FCM"), the Commission can use its risk assessment authority to monitor risk to the FCM.

While fraud remains a possibility, even in a market consisting of sophisticated large commercial firms, existing civil and criminal remedies exist and the extension of the Commission's law enforcement authority into this market appears unwarranted. The participants have not found existing remedies insufficient, nor have they asked the Commission for additional protection.

Finally, I would point out that should the practices within this market change to the detriment of its participants, or the public, or should these transactions take on more characteristics of futures contracts, the Commission can always revisit both the wisdom and the scope of its exemption. For instance, we could tighten the restrictions on who can engage in these transactions. Or, if unforseen events warrant, we could extend 4b coverage to this market after all. Unlike prior law, our exemptive authority under section 4(c) is a flexible statutory tool which can quickly be used to accommodate change. In this regard, I would like to conclude with a few words about the changing marketplace.

Section 4(c) and the Changing Marketplace

As I have noted, Congress gave the CFTC broad exemptive powers as a means of providing certainty and stability to existing and emerging markets. Congress understood that 1992 is not 1922 or even 1972. The regulatory schemes of the past are being stretched by technological changes almost on a daily basis. New statutory approaches and tailored regulations are more appropriate than a single set of rules for diverse instruments and markets. Furthermore, the institutional traders that now dominate the financial markets simply do not need as much protection as individual customers.

Some of our foreign competitors have recognized this. In the U.K., for example, firms dealing with sophisticated investors are subject to less stringent rules -- among other things, less elaborate risk disclosures and the ability to have customers decide whether their funds will be segregated. This produces cost savings for both government and those regulated.

Unless we in the U.S. also recognize these regulatory realities, we will inevitably lose the battle of international competitiveness in financial services. The CFTC is keenly aware of these issues and has done a lot in recent years to address them. New section 4(c) now gives us the opportunity to do more and we hope to do so as Congress intended. Mr. Chairman, we trust we will have your support as we proceed.

I will be happy to answer any questions you may have.

COMMODITY FUTURES TRADING COMMISSION

Exemption for Certain Contracts Involving Energy Products

AGENCY: Commodity Futures Trading Commission.

ACTION: Final order.

SUMMARY: In response to an application for exemptive relief, the Commodity Futures Trading Commission ("Commission") proposed to issue an order exempting from regulation under the Commodity Exchange Act, 7 U.S.C. 1 *et seq.* ("Act"), certain contracts for the deferred purchase or sale of certain specified energy products. 58 FR 6250 (January 27, 1993). This exemptive order is being issued pursuant to the exemptive authority recently granted to the Commission in the Futures Trading Practices Act of 1992. The Commission's Order is intended to provide greater legal certainty regarding trading in these products.

EFFECTIVE DATE: May 20, 1993.

FOR FURTHER INFORMATION CONTACT: Paul M. Architzel, Chief Counsel or Joseph B. Storer, Economist, Division of Economic Analysis, Telephone: (202) 254–6990 or 254–7303, respectively, or David R. Merrill, Deputy General Counsel, Office of the General Counsel, Telephone: (202) 254–9880, Commodity

Futures Trading Commission, 2033 K Street, NW., Washington, DC 20581.

SUPPLEMENTARY INFORMATION:

I. Background

A. Statutory Framework

As the Commission noted in the Notice Proposing Issuance of an Order, 58 FR at 6250, section 2(a)(1)(A) of the Act grants the Commission exclusive jurisdiction over accounts, agreements and transactions commonly known as options, and transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market or any other board of trade, exchange, or market. 7 U.S.C. 2. The Act and Commission rules require that transactions in commodity futures contracts and commodity option contracts, with narrowly defined exceptions, occur on or subject to the rules of contract markets designated by the Commission.[1]

The recently enacted Futures Trading Practices Act of 1992, Public Law No. 102–564 ("1992 Act"), added new subsections (c) and (d) to section 4 of the Act. New section 4(c)(1) authorizes the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof, from the exchange-trading requirements of section 4(a) or any other requirement of the Act other than section 2(a)(1)(B).[2] New section 4(c)(2) provides that the Commission may not grant an exemption from the exchange-trading requirement of the Act unless, *inter alia*, the agreement, contract or transaction will be entered into solely between "appropriate persons", a term defined in new section 4(c)(3).[3] In granting exemptions, the Commission must also determine specifically that the exchange trading requirements of section 4(a) should not be applied, that the agreement, contract or transaction in question will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act and that the exemption would be consistent with the public interest and the purposes of the Act.[4]

B. The Proposed Order

The Commission, on January 27, 1993, published for public comment the proposed order. The Commission proposed this order in response to an application for exemptive relief ("application") filed by a group of entities (the "Energy Group") which represented that each is a producer, processor and/or merchandiser of crude oil, natural gas and/or other crude oil or natural gas product, or is otherwise engaged in a commercial business in these commodities.[5]

The application, submitted pursuant to Section 4(c) of the Act, is for an order exempting from regulation transactions for the purchase and sale of certain energy products through contracts that meet specified criteria. As noted in the Notice Proposing Issuance of an Order, the applicants based their request for an exemption both on the nature of the participants in, and on various representations regarding the usage and form of, these transactions.[6]

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[1] Sections 4(a), 4c(b) and 4c(c) of the Act, 7 U.S.C. 6(a), 6c(b), 6c(c). Section 4(a) of the CEA specifically provides, *inter alia*, that it is unlawful to enter into a commodity futures contract that is not made on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market" for such commodity. 7 U.S.C. 6(a). This prohibition does not apply to futures contracts made on or subject to the rules of a foreign board of trade, exchange or market. 7 U.S.C. 6(a).

[2] Specifically, section 4(c)(1), 7 U.S.C. 6(c)(1), provides:

"In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing, may (on its own initiative or on application of any person, including any board of trade designated as a contract market for transactions for future delivery in any commodity under section 5 of this Act) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction), either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a), or from any other provision of this Act (except section 2(a)(1)(B)), if the Commission determines that the exemption would be consistent with the public interest."

[3] Section 4(c), 7 U.S.C. 6(c)(3), provides that:

"* * * the term 'appropriate person' shall be limited to the following persons or classes thereof:

"(A) A bank or trust company (acting in an individual or fiduciary capacity).

"(B) A savings association.

"(C) An insurance company.

"(D) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.).

"(E) A commodity pool formed or operated by a person subject to regulation under this Act.

"(F) A corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000, or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell support, or other agreement by any such entity or by an entity referred to in subparagraph (A), (B), (C), (H), (I), or (K) of this paragraph.

"(G) An employee benefit plan with assets exceeding $1,000,000 or whose investment decisions are made by a bank, trust company, insurance company, investment adviser registered under the Investment Advisers Act of 1940 (15 U.S.C. 80a–1 et seq.), or a commodity trading advisor subject to regulation under this Act.

"(H) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing.

"(I) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) acting on its own behalf or on behalf of another appropriate person.

"(J) A futures commission merchant, floor broker, or floor trader subject to regulation under this Act acting on its own behalf or on behalf of another appropriate person."

[4] Specifically, section 4(c)(2), 7 U.S.C. 6(c)(2), states:

"The Commission shall not grant any exemption * * * from any of the requirements of subsection (a) unless the Commission determines that (A) the requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and the purposes of this Act; and (B) the agreement, contract, or transaction—

"(i) Will be entered into solely between appropriate persons; and

"(ii) Will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under this Act."

As is frequently the case when Congress grants a regulatory agency authority to act in a manner consistent with "the public interest and the purposes of" its enabling statute, little statutory elaboration is given. As commonly understood, however, an agency, such as the Commission, is to apply this standard against the template of its regulatory scheme. In this regard, the Conference Report states that the "public interest" under section 4(c) includes "the national public interests noted in the [Act], the prevention of fraud and the preservation of the financial integrity of markets, as well as the promotion of responsible economic or financial innovation and fair competition." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78. The Conference Report goes on to state that "[t]he Conferees intend for this reference to the 'purposes of the Act' to underscore their expectation that the Commission will assess the impact of a proposed exemption on the maintenance of the integrity and soundness of markets and market participants." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78. However, the Conference Report on the 1992 Act also states that:

"The Conferees do not intend for this provision to allow an exchange or any other existing market to oppose the exemption of a new product solely on grounds that it may compete with or draw market share away from the existing market."—H.R. Rep. No. 978, 102d Cong., 2d Sess. 79 (1992).

[5] The submission represents that each of the members of the Energy Group is an active participant in the principal domestic and international markets for crude oil and/or natural gas and the products and by-products thereof, which regularly engages in the purchase of such commodities for use in its business operations, the sale of such commodities for use by end-users and the transport of such commodities through pipeline, vessel or truck deliveries.

[6] Specifically, as stated in the application, see 58 FR at 6251, the exemption would:

"* * * preclude participation * * * by members of the general public and * * * limit the * * * [relief] to those appropriate persons who, in the context of their business activities, incur risks related to the underlying physical commodities. In addition, the exemption will require that each * * * Contract [covered by the relief would] impose binding delivery obligations on the parties (with the exception of those covered by * * * [a specified] proviso * * *) and that it not provide

Continued

The applicants further reasoned that the exemption was needed to provide legal clarity and certainty regarding the trading of these products. In this regard, as noted in the Federal Register notice, 58 FR at 6251, the applicants contended that the requested exemption should "recognize() the ability of commercial entities to settle * * * Contracts through the full range of commercially available forms of settlement," and should "allow commercial entities to conduct their necessary business activities in the domestic and foreign oil and gas markets * * * with the requisite degree of legal certainty and comfort."

In addition, the application also addressed the public interest to be served by the Commission's issuance of an order granting this request for an exemption. The Commission included this analysis in the Notice for comment, quoting extensively from it. See, 58 FR at 6251. In this regard, as noted in the Federal Register notice, the applicant reasoned that the exemption would be in the public interest because "[t]hose entities which satisfy * * * the proposed exemption are sufficiently sophisticated and knowledgeable to protect their own interest in connection with * * * Contracts, regardless of whether the regulatory protections afforded under the Act are available * * *;" because "the exemptive relief * * * is necessary in order to permit commercial commodity markets to function effectively * * *;" because "the financial integrity of the markets for such * * * Contracts will be adequately addressed by the limitation of appropriate persons and the measures adopted by each market participant * * *;" and because "such Contracts lack the degree of standardization and fungibility required in order to permit them to be traded on an exchange." *Id.*

Finally, the Commission included seven issues on which it particularly sought public comment. These included the list of eligible "appropriate persons," the Commission's description of the commodities covered by the exemption, its description of the cash market, including the use of brokers and of netting arrangements, the possible effect on contract markets from granting the exemption, and whether section 4b of the Act should be applicable to these transactions.

C. Comments Received

The comment period closed on February 26, 1993. Sixteen comments were received; including eight from active participants in the energy cash or forward markets or entities representing such participants, three from futures exchanges, three from futures industry associations, one from a bar association committee and one from an attorney. All but one of the commenters generally supported issuance by the Commission of the proposed order.

Most commenters confirmed the accuracy of the Commission's description of applicable cash market practices. Several, however, suggested changes to the Commission's description, including in particular, clarifications with regard to the degree of standardization, or individual negotiation, of these contracts. Several further recommended that the Commission clarify additional aspects of the proposed order, including in particular, the applicability of the order to various other types of instruments and other of the Commission's rules and interpretations.

Others recommended that the commission modify certain aspects of the proposed order. These recommendations included modifying the persons proposed to be eligible for this relief, the breadth of commodities covered under the proposed order, and the effective date of the exemption. The opposing commenter, the Chicago Board of Trade ("CBT"), questioned the Commission's statutory authority for issuing the order as proposed, the rationality and fairness of the proposed order and whether the Commission has provided a meaningful opportunity for comment on the statutorily-required determinations regarding the public interest which it must make in issuing this order.

II. The Final Order

Based upon its careful consideration of the application for exemption, the comments received, and its independent analysis, the Commission is issuing an order under its authority in section 4(c) of the Act to exempt specified transactions from Commission regulation. The final order, and in particular, the modifications made to it from the proposal, are discussed below.

A. Statutory and Regulatory Basis of the Order

In proposing to issue this order under section 4(c) of the Act, the Commission made clear that it did "not intend to determine whether Energy Contracts are subject to the Act," nor to "affect the applicability to Energy Contracts of exemptions or interpretations previously issued by the Commission or its staff, including the Statutory Interpretation Concerning Forward Transactions, * * * or the forward contract exclusion set forth in section 2(a)(1) of the Act * * *." 58 FR at 6253, n.18. The CBT, the sole commenter opposing issuance of the proposed order, maintained that issuance of this order, pursuant to section 4(c) of the Act, was inconsistent with prior actions of the Commission and with the CBT's reading of the scope of the Act's section 4(c) exemptive authority.

The Congress, however, did not intend such a restrictive reading of the Commission's 4(c) exemptive authority. On the contrary, the Conferees stated that:

"In granting exemptive authority to the Commission under new section 4(c), the Conferees recognize the need to create legal certainty for a number of existing categories of instruments which trade today outside of the forum of a designated contract market.

"The provision included in the Conference substitute is designed to give the Commission broad flexibility in addressing these products * * *.

"In this respect, the Conferees expect and strongly encourage the Commission to use its new exemptive power promptly upon enactment of this legislation in four areas where significant concerns of legal uncertainty have arisen: (1) hybrids, (2) swaps, (3) forwards, and (4) bank deposits and accounts."

H R. Rep. No. 978, 102d Cong., 2d Sess. (1992) at 80–81.

The Conferees further stated that they did

"not intend that the exercise of exemptive authority by the Commission would require any determination before hand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act. Rather, this provision provides flexibility for the Commission to provide legal certainty to novel instruments where

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either party with the unilateral right to require its counterparty to offset the contract by cash settlement. The Contracts will therefore expose the parties to substantial economic risk of a commercial nature. Further, the Contracts will be entered into between two parties each of which acts as principal, and the material economic terms, including credit terms of the transaction will be subject to individual negotiation between the parties."

The application further explained that the requested exemption:

"* * * focuses on the commercial nature of the parties and the fact that the * * * Contracts impose binding delivery obligations, thereby establishing a "bright line" test. The exemption recognizes that, regardless of the purposes for which the parties enter into a * * * Contract, they may be required by their counterparty to make or receive delivery pursuant to the terms of the Contract. This will permit commercial entities to enter into * * * Contracts for hedging, risk management, pricing or other commercial purposes, provided that the terms of the agreements impose binding delivery obligations, the parties are legally permitted to make and receive delivery and are capable of doing so. In this respect as well, the exemption will facilitate the use of * * * Contracts for legitimate and necessary business purposes." (Citations omitted.)

the determination as to jurisdiction is not straightforward. Rather than making a finding as to whether a product is or is not a futures contract, the Commission in appropriate cases may proceed directly to issuing an exemption."

H.R. Rep. No. 978, 102d Cong 2d Sess., (1992) at 82–83.[7]

Separately, several commenters recommended modifications to the proposed order on the grounds that relief under the order was not as far-reaching as the relief recently granted by the Commission with regard to hybrid instruments or to swap agreements. Thus, one commenter argued that the Commission should make this exemption applicable to any cash-settled energy contract because such transactions arguably would be exempt from regulation under the Commission's Exemption for Certain Swap Agreements. See, 58 FR 5587 (January 22, 1993). A second commenter suggested that the Commission reiterate that this relief was not intended to vitiate the continued vitality of the Commission's Statutory Interpretation Concerning Forward Contracts, 55 FR 39188 (Sept. 25, 1990). Finally, a third commenter requested that the Commission clarify that this exemptive order was not intended to supersede any other Commission rule or interpretation regarding those transactions which have been characterized as forward or trade option transactions.

In proposing this order, the Commission made clear that it did not intend to supersede or vitiate any other of its rules or interpretations, in particular those relating to the section 2(a)(1) exclusion of the Act. 58 FR 6253, n. 18. Rather, this order was proposed in response to a particular application for relief, and was intended to provide legal clarity with regard to certain transactions as described therein in specified commodities. Thus, the Commission is limiting the order to existing practices in these markets, as represented in the application. Nor does the Commission believe that the order should go beyond the representations in the application with regard to practices in these markets to practices which may be permitted under other Commission rules, such as the exemption for swaps in part 35 of its rules. Finally, by confining its order to these transactions, the Commission is not thereby making a determination regarding, or otherwise determining the legality or status of, any other type of transaction or superseding any other rule or interpretation.[8]

B. Commodities Eligible for the Exemption

Several commenters suggested that the Commission not limit this order for exemption to Energy Contracts, but rather extend it to all commodities. One commenter suggested that an exemption limited to energy contracts increases uncertainty regarding forward contract markets in other commodities, thus requiring that the Commission expand this exemption to cover transactions in all commodities. A second commenter argued that there was no legal basis to distinguish energy products from other commodities.

As discussed above, however, the Commission, in proposing this exemptive order, was responding to a particular application for relief. The record before the Commission, and the representations in the application, are limited to trading practices in the markets relating to energy products. See, 58 FR 6251, n.8. Moreover, the Congress specifically directed the Commission to consider the appropriateness of exemptive relief for the crude oil market. H.R. Rep. No. 978, 102d Cong., 2d Sess. at 81–82 (1992).

Based upon the intent of the Congress in enacting this exemptive authority, and upon the limited focus of the application for exemption and the corresponding record, the Commission is of the view that this final order is appropriately limited to transactions in Energy Contracts. Of course, as the Commission noted previously, this exemption in general, and its limitation to Energy Contracts in particular, does not affect the applicability or vitality of existing Commission policies or interpretations regarding transactions in these, or any other, commodities.

Several commenters also requested that the Commission make technical amendments to its enumeration of commodities included within the meaning of the term "Energy Contract." The Commission defined this term in its Notice Proposing Issuance of an Order as, "contracts for the purchase and sale of crude oil, natural gas, natural gas liquids or other energy products, including products derived from crude oil, natural gas or natural gas liquids, and used primarily as an energy source * * *." 58 FR 6251.

In particular, one commenter recommended that "condensates" should be explicitly included within the commodities enumerated. The Commission agrees. Other comments reflected confusion over whether a product must actually be used as an energy source in order to be included within the exemption. The Commission did not intend that inclusion of a particular product within the exemption rest upon a subjective test of intent as to its use as an energy source. For example, a particular company may purchase cargoes of crude oil for use in various commercial activities. The Commission did not mean to exempt only transactions for those specific shipments of the specified products which are used as an energy source. Rather, the enumerated products—crude oil, condensates, natural gas and natural gas liquids, which can be used in their natural state for energy—are included within the exemption regardless of whether the actual or ultimate use of these commodities is as an energy source.

Derivatives of these products are included to the extent that the derivative product is used primarily as an energy source. Again, however, it is the derivative product itself, such as gasoline, heating oil, or diesel fuel, and not the use made of particular lots of a fungible product, which is included under the exemption. The Commission, therefore, in its final order, is clarifying the description of the commodities included in the exemption.

C. Entities Eligible for the Exemption

The Commission, in its Notice, specifically requested comment regarding its enumeration of the entities which would be eligible for exemptive relief. This request elicited diverse opinions which raised several issues. As proposed, the exemptive order would have been applicable to "commercial participants who, in connection with their business activities, incur risks related to the underlying physical commodities, have the capacity to make or take delivery under the terms of the contracts, and are also eligible 'appropriate persons.'" The

[7] In any event, the commenter maintains that "CEA § 4(c) compels the CFTC, at the least, to determine that every instrument it exempts could be a futures contract." In this regard, the Commission notes that the legal uncertainty which this exemptive order addresses was occasioned by the belief of some observers that some of the instruments at issue are indeed futures contracts. See, e.g., *Transnor (Bermuda) v. BP North America Petroleum*, 738 F. Supp. 1472 (S.D.N.Y. 1990). Thus, regardless of the Commission's position on the appropriate characterization for specific types of transactions, the status of some of these transactions under the Act appears likely to be subject to continued dispute, and this potential for uncertainty provides a sufficient basis for the exercise of exemptive authority as to these transactions.

[8] In this regard, the Commission reiterates that the exemption granted here does not affect the applicability to Energy Contracts of the Commission's Statutory Interpretation Concerning Forward Transactions, 55 FR 39188 (September 25, 1990). Any transaction that has been or will be entered into consistent with that Interpretation remains excluded from regulation under the Act.

Commission further defined "eligible appropriate persons" as:

"(1) A bank or trust company (acting in an individual or fiduciary capacity) which is legally permitted and otherwise authorized to engage in such transactions; (2) a corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000, or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell support, or other agreement by any such entity or by an entity referred to in subsections (H), (I) or (J) of Section 4(c)(3); (3) any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing; (4) a broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) acting on its own behalf or on behalf of another appropriate person (as set forth herein); and (5) a futures commission merchant subject to regulation under the Act acting on its own behalf or on behalf of another appropriate person (as set forth herein)."

58 FR 6252.

Several commenters opined that the entities eligible for this relief should be extended to include not only "commercial participants * * * who incur risks related to the underlying physical commodities, [and] have the capacity to make or take delivery * * *." but also to include any appropriate person which is legally authorized to make or take delivery of the physical commodity. These commenters further suggested that an entity could so qualify "by contracting out its obligations to a person or entity that provides such services as storage or transportation of the underlying commodity."

In addition to the above revision to eligibility, several commenters also supported the inclusion of commodity pools within the list of "eligible appropriate person." These commenters supported this revision by reasoning that, "because there is no basis to distinguish between them [commodity pools] for purposes of exemptive relief under section 4(c)," commodity pools should be included within the terms of this exemption "on the same terms as swap transactions."

Other commenters disagreed with this view. One such commenter, a futures exchange, contended that permitting commodity pools to be covered by the exemption was contrary to the proposed order's stated rationale, reasoning that:

"[t]he purpose of the Proposed Order is ostensibly to permit transactions which are entered into for legitimate commercial purposes * * *. To treat a speculative commodity pool * * * as the equivalent of an entity engaged in the business of being a producer, processor and/or merchandiser of energy products, is contrary to the Proposed Order's objective of facilitating commercial activities free of unnecessary regulatory burdens * * *."

Based upon the above reasoning emphasizing the commercial nature of the eligible entities, the commenter further recommended that the Commission state explicitly that eligible parties under the exemption must have, "as part of the routine course of their business activities, * * * the physical capacity to produce, refine, store, transport or otherwise tangibly control the commodity," and questioned the need for conditions related to net worth and total assets. The commenter noted that by limiting the exemption to commercials, it would apply only to sophisticated entities and that the net worth and total asset conditions were therefore unnecessary, potentially excluding unnecessarily "small or start-up commercial entities * * *."

After carefully considering the views of the commenters, the Commission is limiting the final order to those types of commercial participants identified in the proposed order. The Commission is persuaded that this is appropriate in light of the limited nature of the application, and in light of its understanding of the nature of the transactions and the participants currently in these markets.

Consistent with this determination, the Commission is making clear that this exemption remains applicable to transactions that result in risks relating to making or taking delivery of the underlying physical commodities. Accordingly, the category of eligible appropriate persons for this exemption must have a demonstrable capacity or ability to make or take delivery. As the Commission explained in the Notice Proposing Issuance of an Order, at page 6252, "such capacity entails the ability to produce, refine, store, transport or otherwise tangibly control the physical commodity." This can be fulfilled, however, by *bona fide* contractual arrangements for these services.

Moreover, despite some merit in the observation that certain smaller, or start-up commercial firms may be excluded unnecessarily from eligibility for this exemption by the net worth and total assets conditions set forth in section (A)(ii) of the Order, in light of the general nature of the current participants in the markets, the Commission believes that smaller commercial firms, which cannot meet these financial criteria, should not be included. In this regard, size is a relevant proxy for measuring the expertise of, and participation in these types of markets, and for an entity's capability of making or taking delivery in these markets. Moreover, the Commission notes that even smaller or start up firms should be able to meet these financial requirements through the use of various types of permitted guarantees, and thereby qualify for this exemption.[9]

On a separate issue, one commenter requested that the final order also exempt "any person or class of persons offering, entering into, rendering advice, or rendering other services with respect to such Energy Contracts, in connection with such activity." The commenter reasoned that extension of relief to those advising or rendering advice or other such services in connection with these transactions, which was included in the exemption for swap and hybrid instruments, is equally applicable to this proposed exemption.

Consistent with section 4(c)(1) of the Act and the Commission's exemptions for swap and hybrid instruments, the Commission is providing that persons offering, entering into, rendering advice, or rendering other services with respect to such Energy Contracts are eligible for this exemption.[10]

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[9] In this regard, although the Commission has not provided that commodity pools or other collective investment vehicles, including investment companies, or floor brokers and floor traders separately constitute classes of "appropriate persons," to the extent that such entities qualify for exemption as an eligible entity under another category of "appropriate person," they will not be excluded from the exemption. Accordingly, such entities may qualify as appropriate persons if, in connection with their business activities, they incur risks, in addition to price risk, related to the underlying physical commodities, have a demonstrable capacity or ability, directly or through separate *bona fide* contractual arrangements, to make or take delivery under the terms of the contracts, are not prohibited by law or regulation from entering into such contracts, and otherwise meet the qualifications set forth in one of the enumerated categories of appropriate persons. However, any collective investment vehicle formed solely for the purpose of entering into Energy Contracts will not qualify for the exemptive relief provided under the Commission's Order. Of course, a commodity pool operator will continue to be subject to Section 4o of the Act in connection with its solicitations or other activities as a CPO even though it may purchase or direct the purchase of Energy Contracts that are subject to the Commission's Order.

[10] As the Commission noted in the Notice Proposing Issuance of an Order, it did "not intend that the proposed condition that an Energy Contract be a principal-to-principal transaction preclude the use of brokers or other agents in connection with the negotiation of, or the performance or settlement of the obligations under, a contract * * *. 58 FR 6252, n.11. The final order makes clear that it encompasses agents rendering such services, including advisory services, for those activities

However, as explained in connection with the exemption for swap transactions, the application of this exemption to such persons

"engaged in activity otherwise subject to the Act would not be exempt for such activity, even if it were connected to their exempted * * * [Energy Contract] activity. Also in this regard, the Commission wishes to make clear that the exemption does not apply to any financial, recordkeeping, reporting or other requirements imposed on any person in connection with their activities that remain subject to regulation under the Act. Thus, for example, futures commission merchants must continue to account for any liabilities arising out of any * * * [Energy] agreement in meeting the net capital requirements of Commission Rule 1.17 just as they do in the case of other financial instruments not regulated under the Act. Similarly, the risk assessment recordkeeping and reporting requirements imposed on futures commission merchants by new section 4f(c) of the Act apply * * *."

58 FR at 5589.

Finally, several commenters suggested that the Commission clarify the role of written representations in forming a reasonable basis for the belief that a counterparty qualifies as eligible for this exemption. A second commenter requested that the Commission also clarify that a reasonable belief is required as to the counterparty's eligibility with respect to both its capacity for delivery and its inclusion as an eligible appropriate person.

These determinations, that there is a reasonable basis to believe that a counterparty is eligible to enter into the transaction both with regard to its capacity and as an appropriate person, are to be made at the inception of the transaction. Moreover, an eligible entity that has a reasonable basis to believe its counterparty is also an eligible entity when entering into a master agreement may rely on such representations continuing, absent information to the contrary.[11] Compare, 58 FR at 5589.

D. Description of Exempt Transactions

In general, commenters agreed with the accuracy of the Commission's description of the operation of these markets in energy products. However, the entities which filed the application for this exemption, sought, in their comment letter, to distinguish the relative degree of individual negotiation over particular categories of the contract's economic terms. In particular, this commenter pointed out that the terms of the transactions regarding quality and location in many of these markets, because they involve "a single supply location," "are fixed and not the subject of individual negotiation."

The Commission is aware that the terms regarding the quality and location of Energy Contracts, as well as other conventions surrounding their trading are standardized. Nevertheless, these transactions can be distinguished by the fact that, because their credit terms are individual to the counterparties, they are not fungible and are created through the direct negotiation of the parties to the transaction. Compare, 58 FR at 5591.

Several commenters also requested that the Commission confirm that the requirement for binding delivery on the contracts is not affected by inclusion in the contract of a termination right which is triggered by an event of default, such as the insolvency of a counterparty. The Commission concurs that *bona fide* terminations occurring under the terms of a contract, for contingencies such as default or insolvency that are not expected by the parties at the time the contract is entered into, will not invalidate application of the exemption to the transaction. In this regard, however, the Commission cautions that the inclusion of such provisions, and their use, must be *bona fide* and not for the purpose of evading the terms of this exemption.

Finally, one commenter argued that the proposed order is arbitrary because it would have exempted only contracts which were bilateral and not subject to a mutual risk clearing system.[12] The CBT concluded that this is contrary to the public interest because those methods which are included within the exemptive relief are, in its view, inferior to a true clearing system, which is not included within the scope of this order. As the Commission has noted elsewhere in this release, however, this order is responsive to the application for relief and is tailored to current practices in these markets. Accordingly, the order is limited in scope to bilateral, individually negotiated instruments, which is the common practice in these markets.

E. Breadth of Exemptive Relief

The Commission requested comment on whether it should reserve anti-fraud jurisdiction under section 4b of the Act, 7 U.S.C. 6b, over these instruments. No commenter explicitly supported the retention by the Commission of anti-fraud jurisdiction. To the contrary, almost all of the commenters opposed reservation of this authority. Most agreed with the views expressed by one commenter that:

"[G]iven the commercial characteristics of these transactions and the significant requirements to be 'commercial participants' and 'appropriate persons,' the [commenter] * * * does not believe that section 4(b) [sic] of the Act (anti-fraud) should be applied to Energy Contracts."

In this particular instance, the Commission concurs with the commenters that it need not retain section 4b authority, to whatever extent that section of the Act would otherwise be applicable to these transactions.[13] However, sections 2(a)(1)(B) of the Act and the provisions of sections 6(c), 6c, 6(d) and 9(a)(2) of the Act, to the extent that these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, will continue to apply.[14]

Finally, several commenters requested that the Commission broaden the exemption by making its application retroactive. As proposed, the Commission's order would have been effective upon publication for all executory transactions. Various commenters objected. One reasoned that:

"[I]f the CFTC determines that issuing the proposed exemption is consistent with the public interest, its determination should eliminate any legal uncertainties with respect to Energy Contracts entered into before as well as after the effective date of the exemption. The CFTC's final rules exempting

[11] As under the Part 35 rules, where a counterparty has ceased to be eligible for this exemption, an eligible entity nevertheless may enter into a "closing transaction" with the counterparty to terminate all obligations between them. See, 58 FR at 5589, n. 18.

[12] As the Commission noted in the Notice Proposing an Order:

"The requirement that Energy Contracts be bilateral and subject to individual negotiation is intended to assure that the transactions would not be subject to a clearing system where the credit risk of individual participants of the system to each other, with respect to a transaction to which each is a counterparty, would effectively be eliminated and replaced by a * * * system of mutualized risk of loss that binds members generally whether or not they are counterparties to the original transaction."—58 FR at 6253, n. 15.

[13] Of course, that is not to say that the Commission's decision not to reserve Section 4b anti-fraud jurisdiction will leave market participants without legal recourse for fraud in connection with these transactions. Market participants will continue to have available those state and common law remedies which have been applicable to these markets from their inception.

[14] Moreover, as the Commission noted in its Notice Proposing Issuance of an Order, at 58 FR 6253, n.19, this order "would not affect the applicability or protections of state law (other than gaming or "bucket shop" laws), or antifraud statutes of general applicability, to the exempted Energy Contracts or any other protections provided by other applicable federal laws. Congress specifically noted that, in exempting an instrument from the Act, the Commission cannot exempt it from applicable securities and banking laws and regulations." H.R. Rep. No. 978, 102d Cong., 2d Sess. 83 (1992).

certain swap and hybrid transactions apply retroactively, and * * * [the commenter] sees no reason why the proposed exemption should not also apply to existing Energy Contracts."

In light of the Commission's objective in issuing this order—to provide greater legal certainty regarding the trading of these instruments—and the uniform opinion of the commenters that the retroactivity of the order is an important component of providing that certainty, the Commission has determined that upon the order's effective date, it will apply retroactively, to all such transactions entered into on or after October 23, 1974. This is consistent with the Commission's recent promulgation of rules exempting certain swap transactions, 58 FR 5587, and certain hybrid instruments, 58 FR 5580 (January 22, 1993).

F. Public Interest and Purposes of the Act Determinations

1. Public Interest

In determining that its actions are consistent with "the public interest and the purposes of" its enabling statute, an agency, such as the Commission, applies the standard against the template of its over-all regulatory scheme. In this regard, the Conference report states that the "public interest" under section 4(c) includes the "national public interests noted in the [Act], the prevention of fraud and the preservation of the financial integrity of the markets, as well as the promotion of responsible economic or financial innovation and fair competition." H.R. Rep. No. 978, 102d Cong., 2d Sess. 78 (1992).[15] The Conference Report goes on to state that "[t]he Conferees intend for this reference to the 'purposes of the Act' to underscore their expectation that the Commission will assess the impact of a proposed exemption on the maintenance of the integrity and soundness of the markets and market participants." *Id.*

Energy Contracts are used by certain commercial entities that are engaged in the production, refining, processing or merchandising of crude oil, condensates, natural gas, natural gas liquids, or their derivatives which are used primarily as an energy source. Energy Contracts are used by these entities and other commercial entities in the conduct of their businesses. Reportedly, these markets have been chilled by the legal uncertainty surrounding these transactions. The Order should reduce uncertainty, thus allowing participants to negotiate and structure Energy Contracts in ways that most effectively address their economic needs, and thereby enhancing the global competitive position of U.S. businesses.

As noted by one commenter,

"Congress, when considering passage of the [Futures Trading Practices of 1992], acknowledged that the mandatory exchange-trading requirement, if applied to every commodity transaction having the indicia of a futures contract, may cause foreign market participants to engage in such transactions outside of the United States, creating 'competitive disadvantages for U.S. participants.'"

2. Material Adverse Effect on Regulatory or Self-Regulatory Responsibilities

In making this determination, Congress indicated that the Commission is to consider such regulatory concerns as "market surveillance, financial integrity of participants protection of customers and trade practice enforcement."[16]

The record before the Commission does not support a conclusion that the purpose of the Act or the Commission's regulatory efforts thereunder have been adversely affected by the use of Energy Contracts or will be so by the issuance of the order. Energy Contracts have been entered into by commercial participants in the energy markets for a number of years, without any apparent adverse impact on market surveillance, financial integrity of participants, protection of customers and trade practice enforcement of regulated markets.

Specifically, the Commission has addressed concerns regarding financial integrity and customer protection through the requirement that Energy Contracts may only be entered into and/or only be transacted on behalf of "appropriate persons", as defined above. This approach ensures that such transactions involving Energy Contracts will be limited to sophisticated entities engaged in the businesses described above and who are financially able to bear risks associated with such transactions.[17]

The Commission also noted that the existence of Energy Contracts to date has not affected the ability of futures exchanges to fulfill their self-regulatory duties.[18] In this regard, commenters have asserted that the futures market and the Energy Contract markets are linked, with many of the same commercial entities using Energy Contracts also using the energy futures markets for hedging purposes. By creating a more certain legal environment for Energy Contracts, the potential for systemic risk due to disaffirmance of such contracts as invalid under the Act is reduced, and there is no reason to conclude that the exchanges' self-regulatory responsibilities will be adversely affected by permitting transactions under Energy Contracts to continue on this basis.[19]

3. Anticompetitive Considerations

Section 15 of the Act provides, in relevant part, that the Commission must consider the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives, policies, and purposes of the Act in adopting any rule, regulation, or exemption under section 4(c).[20] Thus, a formal analysis under the antitrust laws is not, by itself, dispositive of the issues raised by a Commission action.[21] As a result, the Commission is not compelled by section 15 to take the least anticompetitive course of action. Rather, where alternatives with varying degrees of regulatory benefit exist, the

[15] One commenter, a futures exchange, in its letter notes that in addressing certain elements of the public interest for futures trading, Congress has indicated that contract market designation and regulation under the Act is necessary to avoid creating an undue burden on commerce. *See* Section 3 of the Act. Seventy years after the enactment of Section 3, however, Congress enacted Section 4(c) authorizing exemptions from Section 4(a) of the Act, for certain products, because "traditional futures regulation * * * may create an inappropriate burden on commerce." H.R. Rep. No. 978, 102d Cong., 2d Sess. 80 (1992).

[16] H.R. No. 978, 102d Cong., 2d Sess. 79 (1992).

[17] In enacting the 1992 Act, Congress explicitly authorized exemptions from all provisions of the Act (except section 2(a)(1)(B)) and simultaneously enacted a "conforming amendment" to section 12(e)(2) explicitly acknowledging that State antifraud statutes of general applicability would continue to apply to exempted transactions.

[18] In this respect, neither of the two futures exchanges commenting on the proposal indicated that the proposed order will adversely affect their self-regulatory responsibilities.

[19] The Commission is unaware of any Energy Contracts that provide for settlement by tendering an exchange-created delivery instrument, such as an exchange-approved depositary or depository receipt or shipping certificates, that is specified in the rules of any designated contract market. Energy Contracts which did specify such delivery instruments could have an effect on certificated supplies for settlement of designated futures or option contracts and, accordingly, the creation of Energy Contracts specifying such delivery instruments should only occur after consultation with the Commission.

[20] Specifically, section 15, as amended by section 502(b) of the 1992 Act, provides:

"The Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or adopting any Commission rule or regulation (including any exemption under sections 4(c) or 4c(b), or in requiring or approving any bylaw, rule, or regulation of a contract market or registered futures association established pursuant to section 17 of this Act."

[21] *See Gordon* v. *New York Stock Exchange*, 422 U.S. 659, 690–691 (1975); *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963).

Commission may adopt the approach that appears to be the most likely to achieve the objectives, policies, and purposes of the Act, even if that approach is not the least anticompetitive.[22]

Accordingly, section 15 requires the Commission to balance the likely anticompetitive impact of its action against the objective, policy, or purpose of the Act which that action may further. And, although the Commission must consider the public interest in maintaining or promoting competition, it need not weigh this interest equally against an objective, policy or purpose of the Act being served in reaching its final determination.

The Commission's consideration of the proposed order and its evaluation of the comments received in this regard has led it to conclude that any possible anticompetitive effects are clearly outweighed by the order's furtherance of the policies, purposes and objectives of the Act. First, the proposal does not appear to raise any significant competitive issues. As a number of commenters noted, the exemption, by improving the legal certainty of Energy Contracts, will reduce the risk that the physicals market may be disrupted. Commenters also noted that granting the exemption could result in expanded participation by foreign and domestic energy companies. Accordingly, the exemption furthers a fundamental objective of section 4(c)(1) of the Act, i.e., promoting "responsible economic or financial innovation and fair competition."

For the reasons explained above, the Commission, based upon the appropriate determinations made in accordance with the standards set forth in section 4(c) of the Act, hereby issues the following Order:

Order of the Commodity Futures Trading Commission Exempting From Regulation (Except as Specified) Certain Energy Contracts

Whereas, it is the Commission's understanding, based upon representations contained in an Application for Exemption, dated November 16, 1992, that contracts for the purchase and sale of crude oil, condensates, natural gas, natural gas liquids, or their derivatives which are used primarily as an energy source, by their terms, impose binding delivery obligations on the parties ("Energy Contracts"). These Energy Contracts do not provide either party with the unilateral right to offset the contract or to discharge its obligation under the contract by a cash payment, except pursuant to a *bona fide* term of the contract permitting the unilateral termination of the contract for force majeure, insolvency or bankruptcy of one of the parties, default or other inability to perform, unexpected at the time the contract is entered into ("*bona fide* termination right"). Energy Contracts thus expose the counterparties to the substantial economic risk of a commercial cash market transaction in which delivery of the product is required pursuant to the terms of the contract. Further, Energy Contracts are entered into between principals; and their material economic terms (including, in particular credit terms) are subject to individual negotiation between the parties.[23]

The Commission further understands that parties to Energy Contracts satisfy or otherwise settle their obligations through several types of commercially acceptable arrangements, including the seller's passage of title and the purchaser's payment and acceptance of the commodity underlying the contract.[24] Passage of title and acceptance of the commodity constitutes performance under a *bona fide* contract regardless of whether the buyer lifts or otherwise takes delivery of the cargo or receives pipeline delivery, or as part of a subsequent separate contract, passes title to another intermediate purchaser in a "chain", "string" or "circle" within a "chain."

The physical delivery obligation specified in an Energy Contract entered into between two parties can also be satisfied through various other arrangements between the parties. For example, in the case of crude oil and crude oil products, the physical delivery obligation could be satisfied by exchanging one quality, grade or product type for another quality, grade or product type. Such transactions are referred to in the industry as "grade and/or quality swaps" or "exchanges." In addition, the obligation could be satisfied by location swaps.

In addition, two parties to an Energy Contract may enter into a bilateral "netting" or other similar agreement, subsequent to the execution of an Energy Contract.[25] Under such an agreement, the two parties agree to "net" or "book out" the obligations imposed under two or more Energy Contracts which provide for delivery of the same commodity at the same delivery location and during the same delivery period and thus cancel each other. Such a netting agreement can be entered into at the time that the canceling Energy Contract is originated, or subsequently, through a different agreement, at a time prior to when performance on the contracts otherwise would be due.[26]

The Commission further understands that under current market practice, the parties to the original contract may enter into a subsequent agreement ("second contract") which provides for settlement in a manner other than by physical delivery. The second contract, however, cannot stand alone as an independent transaction; it is incidental to a pre-existing, *bona fide* Energy Contract. Moreover, the establishment of the second contract cannot be made a pre-condition of the initial Energy Contract; *e.g.*, one party cannot require its counterparty to agree in advance to the establishment of the second contract as a condition of acceptance of the initial Energy Contract. Accordingly, the second contract is a separately negotiated agreement and, if the counterparty subsequently does not agree to the second contract, the parties remain obligated in accordance with the binding delivery requirements imposed under the initial Energy Contract.

Existing market practice also permits three or more parties, upon finding that they form a "chain", or a "string" or "circle" within a "chain", to satisfy their obligations under an Energy Contract, whether or not title passes or

[22] See, e.g., *British American Commodity Options Corp. v. Bagley*, Comm. Fut. L. Rep. (CCH), 20,245 at 21334 (S.D.N.Y. 1976), *aff'd in part and rev'd in part*, 552 F.2d 482 (2d Cir. 1977), *cert. denied*, 434 U.S. 938 (1977).

[23] Parties to Energy Contracts may establish bilateral collateral or other credit protection arrangements, such as a letter of credit or other documentation of funds availability, to address credit issues.

[24] Cash market transactions in crude oil, petroleum products, natural gas and natural gas liquids, as well as other energy related commodities in which physical delivery is made, are effected through payment by the buyer and transfer of title by the seller to the buyer.

[25] In the energy markets, the terms "book out" (crude oil) and "book transfer" (other petroleum products) are cash market terms that generally refer to the cancellation or netting of physical delivery obligations between parties, the primary purpose of which is to prevent or minimize the uneconomic movement of the physical commodity.

[26] Rather than agreeing to net particular canceling Energy Contracts, two frequent counterparties, for purposes of ease of administration, may use a "master," or other form of bilateral agreement to achieve the same result. This master agreement, established prior to entry into the Energy Contracts, provides that the two counterparties agree to net energy Contracts of the same commodity at the same location and during the same delivery period. This agreement replaces the practice that counterparties agree to net particular canceling Energy Contracts, either to the time the second contract is entered into, or by a separate, subsequent agreement, with the understanding that all contracts between them which cancel each other will be netted, unless they have agreed not to apply the prior netting agreement at the time of entry into an Energy Contract.

is deemed to pass, through a subsequent, separate agreement, with unanimous consent of the parties, to "book out" and satisfy their obligations through separately negotiated bilateral cash payments or other mutually acceptable terms. It has been represented to the Commission that such arrangements are common in the energy cash market.[37] They are standard commercial practice to avoid and/or minimize transaction costs, non-economic payments and product movements, and for reducing the number of transactions necessary to perform all obligations between parties pursuant to the contracts which are "booked out."

And whereas, this order is limited to (A) commercial participants who, in connection with their business activities: (1) incur risks, in addition to price risk, related to the underlying physical commodities; (2) have a demonstrable capacity or ability, directly or through separate *bona fide* contractual arrangements, to make or take delivery under the terms of the contracts; (3) are not prohibited by law or regulation from entering into such Energy Contracts; (4) are not formed solely for the specific purpose of constituting an eligible entity pursuant to this Order; and (5) qualify as one of the following entities:

(i) A bank or trust company;

(ii) A corporation, partnership, proprietorship, organization, trust, or other business entity with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000, or the obligations of which under the agreement, contract or transaction are guaranteed or otherwise supported by a letter of credit or keepwell support, or other agreement by any such entity or by an entity referred to in subsections (A), (B), (C), (H), (I) or (J) of section 4(c)(3);

(iii) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.);

(iv) A futures commission merchant subject to regulation under the Act; or

(B) Any governmental entity (including the United States, any state, any municipality or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

And whereas, this order also encompasses persons offering, entering into, rendering advice or rendering other services with respect to the agreement, contract, or transaction which is the subject of this Order, for such activity;

The Commission, pursuant to section 4(c) of the Act, hereby exempts from all provisions of the Commodity Exchange Act, 7 U.S.C. 1 *et seq.*, except sections 2(a)(1)(B) of the Act and the provisions of sections 6(c), 6c, 6(d) and 9(a)(2) of the Act, to the extent that these provisions prohibit manipulation of the market price of any commodity in interstate commerce or for future delivery on or subject to the rules of any contract market, the following transactions, entered into on or after October 23, 1974:

Contracts for the purchase and sale of crude oil, condensates, natural gas, natural gas liquids or their derivatives which are used primarily as an energy source, and which:

(1) Are entered into by and between participants covered by this Order, having at initiation of the contract a reasonable basis to believe that its counterparty is also within the terms of this Order;

(2) Are bilateral contracts between two parties acting as principals, the material economic terms of which are subject to individual negotiation by the parties; and

(3) Impose binding obligations on the parties to make and receive delivery of the underlying commodity or commodities, with no right of either party to effect a cash settlement of their obligations without the consent of the other party (except pursuant to a *bona fide* termination right), *provided, however*, that the parties may enter into a subsequent book out, book transfer, or other such contract which provides for settlement of the obligation in a manner other than by physical delivery of the commodity specified in the contract.

Issued in Washington, DC, this 13th day of April, 1993, by the Commission (Acting Chairman Albrecht and Commissioner Dial concurring, Commissioner Bair dissenting).

Jean A. Webb,

Secretary of the Commission.

Concurring Opinion of Acting Chairman William P. Albrecht

Today we have before us an exemption for large commercial participants in off-exchange energy based transactions. These transactions compose a large ongoing market for energy products of importance to U.S. and international commerce. We are considering this exemption in response to a petition submitted by several market participants who seek further certainty that this market is outside CFTC regulatory jurisdiction.

This market for energy products has been in existence for many years and over those years it has grown in size, importance and complexity. The Commission has never regulated this market, nor has it sought to regulate it. The market is characterized by principal to principal transactions between large sophisticated commercial entities. The Commission is not aware of fraudulent practices perpetrated against the general public by the participants in this market, nor indeed have any of the commercial participants in this market complained to the Commission of fraudulent practices by other participants. Also, there generally do not appear to be any concerns about the ability of these market participants to perform their obligations. Absent two events it is doubtful that the petitioners would have brought their request to us.

First, a vast number of transactions previously not considered to be within the scope of the Commodity Exchange Act were brought into question by a single court decision, *Transnor (Bermuda)* v. *BP North America Petroleum*, that applied the CEA to a foreign market of mostly commercial to commercial transactions. The Commission did not believe these transactions were the off-exchange "futures" contracts that Congress intended to prohibit and the Commission issued a statutory interpretation to that effect. Obviously, the parties in the 15 day Brent Market—major international oil and trading companies—should not have been able to escape their contractual obligations in these transactions by claiming the transactions were void as illegal futures contracts.

Second, the Commission's new exemptive authority granted by Congress in the Futures Trading Practices Act of 1992 frees the Commission from the constraints of the futures/forwards dichotomy. In this regard the exemptive authority allows the Commission to approach situations on a case by case basis. This freedom to try new approaches is the real value of the exemptive authority. The Commission is now able to review petitions or requests for exemption on a public policy basis in light of the seventy year history of regulating futures contracts as well as the current and expected needs of commerce.

I believe that public policy dictates that the Commission exempt the market before us today from Commission regulation. There does not appear to be any reason sufficient to justify Commission regulation, nor any necessity for the Commission to involve itself in this market. I view this market,

[37] The use of brokers, agents or a third-party to identify the existence of a "chain" or to facilitate the bilaterally negotiated "book out" of transactions forming a "chain" is not deemed to constitute a clearing system. The Commission has been advised that there are a number of third-party brokers and agents who provide this service in the energy cash market.

its transactions, and participants as clearly within the scope intended by Congress for the exercise of the Commission's new exemptive authority. Indeed, in enacting the exemptive authority Congress specifically directed us to address the crude oil market.

Some have argued that the Commission should not exempt these markets from the anti-fraud requirements of section 4b of the CEA. I disagree. First, in this commercial to commercial market there has not been shown any need for the Commission to take any action to prevent fraud. Second, as the Commission will not be involved with ongoing regulation of this market, or even be more than generally knowledgeable of the activities in this market, it will not possess the information necessary to enforce Section 4b. Third, the presence of 4b will be of little potential benefit and great potential harm. The terms of 4b limit its application to futures contracts entered into for or on behalf of a customer—serious limitations where the transactions are largely principal to principal and where the individual transactions would have to be proved to be futures contracts. Further, if a party to one of those exempt transactions were to seek to base a complaint on Section 4b, they would face the problem that the Commission has also chosen to exempt this market from section 22 of the Act, thus they may not have any right to bring a private action under the CEA. The potential harm of maintaining 4b jurisdiction is that such action on one hand may hinder the development of this market, undermining the legal certainty we seek to assure today and on the other hand give some the illusion of federal supervision by the CFTC, when in fact the CFTC does not and can not supervise this market.

Exemptive Order for Certain Energy Contracts, Concurring Opinion of Commissioner Joseph B. Dial

After the enactment of the FTPA, we find ourselves in the peculiar situation of possessing an exemptive authority that does not require our determination that something is a futures contract in order to exempt it from our jurisdiction. At least that's what the conference report language tells us.

Accordingly, we have worked diligently to avoid stepping on the legal and policy land mines inherent in this authority. I have gone over the new law and the conference report, as well as the case law and Commission interpretations in the area of forward contract definition. In light of concerns regarding Section 4b of the Act and this exemption, and the differing institutional opinions on this issue, I'd like to make clear how I view this exemption.

First, it is understandable that people make a comparison between the swaps and hybrids exemptive authority this Commission exercised in January, and the exemptive authority we are approving today. We are new at this endeavor, and so have little background as an institution in using this particular authority. Therefore, I think it is important to note some of the differences I see between today's exercise and the exemptive action the Commission took on January 14, 1993.

The forwards markets are understood to be fundamentally different from the swaps markets. In effectuating the swaps exemptive authority, we did not have the longstanding institutional experience that we do with forwards markets and their evolution. Swaps are a relatively new field of complex financial transactions, and are still the object of intense study by the government and the private sector. Therefore, the Commission deemed it prudent to retain 4b so that, for example, if in the unlikely event an unscrupulous entity were to convolute a swaps transaction into a boilerroom-type futures transaction, we could act expeditiously against such conduct.

Conversely, with the exercise of exemptive authority as to the energy contracts in current usage as described in this proposal, we have extensive legal and policy background relating to these well-known commercial markets.

As my colleagues are aware, I take a strong pro-enforcement stance in the investigation and prosecution of fraud in the markets we regulate. However, after reviewing the current request for exemption for existing markets, and in light of the Brent interpretation and the continuing evolution of these commercial transactions, I believe it more proper, from a policy and legal standpoint, not to retain 4b authority as to contracts described in this exemption. I came to this view after interpreting the conference report language regarding the use of exemptive authority in this area to indicate a need for clarification of our Brent interpretation. While I recognize that this exemption is regarded as an expansion of Brent, I view our action here today to be in accordance with the Congressional directives in the FTPA. Therefore, I've concluded that 4b should not be retained regarding exemptive authority for existing practices in these energy contracts.

If, after approval today, someone commits a fraudulent act relating to what appears on the surface to be an exempt energy transaction within this proposal, but is proven later to be a futures contract outside the parameters of this proposal, then the Commission of course has authority to prosecute that fraudulent conduct under 4b.

This exemption is unique, given its factual and legal background. I believe that by approving it we are exercising our exemptive authority in a manner consistent with Congressional intent. We are allowing existing energy contract practices in these markets, whose historical record is well-documented, to continue to perform a useful function in the international marketplace.

Dissenting Opinion of Commissioner Sheila Bair

Mr. Chairman, I have decided, albeit reluctantly, to vote against the final order before us today because of its failure to retain the general anti-fraud provisions contained in section 4b and 4o of the Commodity Exchange Act. Let me just briefly summarize the policy reasons why I believe we should retain such authority in the energy exemptive order.

In my view, the final order, by its terms, is not limited to forward contracts traditionally excluded from the jurisdiction of this agency. Rather, it goes significantly beyond the forward contract exclusion and extends to transactions which could very well meet the criteria for illegal off-exchange futures contracts traditionally applied by this agency and the courts. I believe that exempting such transactions from statutory provisions as basic and central to our regulatory scheme as Sections 4b and 4o is a serious misapplication of our new exemptive authority, and sets a dangerous precedent.

The Proposed Order Goes Beyond the Forward Contract Exclusion

As I stated, the order, by its terms, is not limited to forward contracts. Further, the fact that we are proceeding with an exemption from our jurisdiction, as opposed to describing a class of excluded transactions, demonstrates implicit recognition that some of the transactions which we are exempting could indeed be futures. Moreover, markets which qualify for this exemption operate very differently from traditional forward markets. The contracts are standardized, there is a large amount of speculative activity, and the overwhelming majority of transactions do not result in delivery, but are cash settled.

Indeed, the only arguable distinguishing feature between exempt transactions under the order and the typical gasoline boiler room operation is the requirement that participants be commercial entities. Yet, the "commerciality" requirement in the order is by and large undefined. Moreover, the Commission, has never recognized an exemption to its jurisdiction based solely on the "commerciality" of the participants, nor can I see any policy reason why commercial firms engaging in futures transactions should not have the basic protection of our anti-fraud provisions.

The "Sophistication" of Market Participants is Not a Valid Basis for Providing an Anti-Fraud Exemption

It has been argued that because the participants in exempt energy transactions are "sophisticated" institutional users or entities of high net worth, they don't "need" CFTC anti-fraud protections.

At the outset, I would note that if we are to rationalize exemptions from anti-fraud and other components of our regulatory scheme on the basis of the "sophistication" of market users, we might as well close our doors tomorrow, because approximately 98% of users of regulated, exchange-traded futures meet the eligibility rquirements of our swaps rule, and, these financial requirements are much higher than those in the order. Moreover, large firms are defrauded—we have brought a number of enforcement actions where the victims have been so-called institutional or sophisticated investors. I would also add that this order does allow for indirect public participation through collective investment vehicles, and through the guarantee provisions in paragraph ii of the appropriate person portion of the order.

The Existence of State Anti-Fraud Remedies is Irrelevant to the Issue at Hand

In addition, I do not view the existence of state anti-fraud remedies as a valid policy basis for providing an exemption from the CEA's basic anti-fraud protections. State remedies are always available in the absence of federal protections. It is important to remember that it was the historical inadequacy of state law protections, however, that gave rise to federal regulation of financial markets in the first place.

Retaining Residual Anti-Fraud Authority Would Not Place An Onerous Burden on the Markets

I also do not believe that we would place an onerous burden on the markets by retaining anti-fraud authority.

If we retained 4b and 4o, they would apply to those fraudulent transactions which we could demonstrate were futures contracts and thus otherwise subject to the CEA. In addition, since we are preserving the Brent Oil statutory interpretation, defendants would still be able to rely on that document as a shield against CFTC actions. Moreover, participants in these markets have always run the risk that transactions which do not meet the statutory interpretation could be deemed "futures" and thus subject to the whole plethora of CEA requirements, not just anti-fraud prohibitions. That is precisely why we are moving forward with this order. Is it really that much of a burden on market participants to retain a sliver of authority regarding fraudulent activity?

It should also be emphasized that 4b and 4o apply no more of an onerous burden on these markets than does state anti-fraud law. Indeed, given conflicts in state law, providing federal forums and remedies to these transactions is, if anything, less onerous.

Providing an Anti-Fraud Exemption Would Set a Dangerous Precedent and Is Unnecessary Given Our New Exemptive Authority

Finally, I think we are setting a dangerous precedent by not retaining anti-fraud authority. I can see no valid policy reason why to decide to retain anti-fraud authority in our swaps rule, yet to decline to do so here. My fear is that we will inevitably raise the expectations of other potential applicants for exemptive relief that they will also be able to escape Sections 4b and 4o.

What is especially frustrating to me is that we do not need to paint ourselves into this corner. The main reason why the CFTC sought general exemptive authority in last year's reauthorization was so that we would have the flexibility to craft appropriately tailored exemptive relief based on public policy considerations, instead of having to deal with the "all or nothing" jurisdictional decisions we had to make in the past. Yet, we are still following this "all or nothing" approach, when in my view, we should be carefully weighing individual aspects of our regulatory structure and making a reasoned determination as to which requirements should and should not apply to a particular class of transactions. And, for the reasons I have stated, I do not believe the case has been made for providing an exemption from basic anti-fraud provisions.

[FR Doc. 93-9037 Filed 4-19-93; 8:45 am]

BILLING CODE 6351-01-M

Statement of Sheila Bair

Commissioner
Commodity Futures Trading Commission

Before the House of Representatives Committee on Agriculture

Subcommittee on Conservation, Credit
and Rural Development

April 28, 1993

Mr. Chairman, members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the Commission's recent order exempting certain energy contracts from the Commodity Exchange Act. I voted against the exemptive order because it did not retain the general anti-fraud provisions of the Act. I voted as I did because I think that exempting these transactions from statutory provisions as basic and central to our regulatory scheme as Sections 4b and 4o is a serious misapplication of our new exemptive authority, and sets a dangerous precedent. Before I discuss the specific policy reasons underlying my view that the Commission should retain such authority, I would like to discuss some general issues related to the energy exemption.

At the outset, let me say that I believe that the Commission had the statutory authority to grant energy contracts an exemption from the provisions of the Commodity Exchange Act, including the antifraud provisions of Sections 4b and 4o. Section 4(c) of the Act, which was recently added, gives the Commission the authority to "exempt any agreement, contract or transaction . . . <u>that is otherwise subject to subsection (a)</u> . . . from any of the requirements of subsection (a) or from any other provision of the Act (except section 2(a)(1)(B)) if the Commission determines that the exemption would be consistent with the public interest." (emphasis added).

Subsection (a) of Section 4 of the Act, referred to in the Commission's exemptive authority, requires that futures contracts be traded on contract markets designated by the Commission. Thus, under Section 4(c), the Commission has the authority to exempt futures contracts from the provisions of the Act. The legislative history to Section 4(c) makes it clear that Congress did not intend that the Commission needed to make a determination that a product is a futures contract before granting it an exemption from the Act. However, any exemption granted by the Commission is effective only to the extent that the product exempted is a futures contract subject to the Act. The Commission's exemptive order for energy contracts did not specify whether those contracts are futures. The Commission's exemptive order did leave that possibility open and is, in my view, effective to the extent that the energy contracts at issue are futures.

Further, let me say that I did not oppose, in concept, some type of exemption from the Act for the Brent crude oil contracts. As the legislative history to Section 4(c) noted, one court in a decision in <u>Transnor (Bermuda) Limited v. BP North America Petroleum</u>, has found that these contracts are futures contracts. The legislative history to Section 4(c) encouraged the Commission to review the situation regarding Brent contracts and "to determine whether exemptive or other action should be taken." Conf. Rep. at 82.

I was amenable to a properly tailored exemption for the Brent market because I could see why uncertainty as to the legal status of this market persisted after the Commission's September 1990 issuance of a Statutory Interpretation determining that Brent contracts were forward contracts excluded from the Act. As former Commissioner Fowler West's dissent to the Brent Statutory Interpretation correctly points out, the Brent Statutory Interpretation went far beyond generally accepted criteria in defining Brent contracts as forward contracts. In the Brent Statutory Interpretation, the Commission was forced to depart from the traditional requirement that the parties to a forward contract contemplate delivery and that delivery routinely occurs in order to avoid concluding that Brent market transactions were illegal off-exchange futures. The Commission had little choice but to take such an approach to defining forwards, because it lacked the authority to exempt futures contracts from the Act.

The Brent Statutory Interpretation, however, did not provide the legal certainty that the Brent market participants sought. The Brent Statutory Interpretation was such a departure from the traditional view of forwards that it left open the possibility that a court could disagree and find that Brent contracts were futures contracts subject to the Act, in spite of the Commission's view that they were not. I believe that this is exactly the type of situation that the Commission's exemptive authority is meant to address. Legitimate, ongoing commercial activity was being threatened by uncertainty about the legal status of conducting such activity off an organized exchange. The Commission could end that uncertainty by granting an exemption from the Act. In such a case, I believe that the proper course was for the Commission to grant an exemption retaining, at the least, anti-fraud and anti-manipulation authority. I would have supported an exemption for the Brent market on these terms.

Retention of anti-fraud and anti-manipulation authority is even more important to me in the context of the exemptive order issued by the Commission because this order grants relief significantly beyond the Brent market and the Brent Statutory Interpretation. The Brent Statutory Interpretation was crafted to address contracts for the delivery in the Brent oil market, where a single cargo consists of 500,000 barrels of oil with a current market value in excess of $10 million. The energy exemption, on the other hand, encompasses any contract for the purchase and sale of all types of crude oil as well as condensates, natural gas, natural gas liquids or the derivatives of these commodities, without regard to the size of the transaction.

Further, expansion of the types of contracts granted relief necessitated expansion of the types of offset arrangements permitted under the exemption in order to reflect the practices of markets other than the Brent market. The Brent Statutory Interpretation described several alternatives to delivery: strings, chains, loops and book-outs. These arrangements are all negotiated subsequent to entry into a Brent contract. Because there is no preexisting obligation to enter into such arrangements, parties to

Brent contracts retain the risk that they will have to make or take delivery in the absence of counterparty willingness to offset the delivery requirement, and that someone, in fact, will always have to take delivery of each Brent cargo.

The energy exemption permits these alternatives to delivery as well as the use of master agreements established prior to entry into an energy contract. Master agreements, used in some of the markets covered by the exemption, provide that the two counterparties agree to net energy contracts of the same commodity at the same location and during the same delivery period. The presumption under a master agreement is that all contracts between the counterparties which cancel each other will net, unless the parties agree not to apply the prior netting agreement at the time of entry into an energy contract. Participants in these markets that use master agreements can net all transactions in a particular month, with no intention to take delivery of any amount of oil, and no ultimate movement or change in ownership of the commodity .

In addition, the scope of entities eligible for the energy exemption is significantly broader than those described in the Brent Statutory Interpretation. The Brent Statutory Interpretation described the participants in the Brent market as producers, processors, refiners and merchandisers of petroleum products and other entities that buy and sell petroleum in connection with a line of business. The entities eligible to participate in exempt energy contracts include, among others, banks, governmental entities, including municipalities, corporations, partnerships and proprietorships with a net worth exceeding $1 million or total assets exceeding $5 million or the obligations of which are guaranteed or supported by a line of credit from an eligible entity, including a bank, savings and loan, broker-dealer or futures commission merchant. A footnote to the exemptive order makes clear that commodity pools and other collective investment vehicles as well as floor brokers and floor traders can be eligible participants in exempt energy contracts so long as they meet the net worth or guarantee requirements for business entities and qualify as "commercials" for purposes of the order.

This expansion of eligible entities would not be so significant if the commerciality requirement of the Brent Statutory Interpretation had been preserved. However, this requirement has been loosened considerably. The Brent Statutory Interpretation emphasizes that transactions in Brent contracts are entered into for commercial purposes in normal commercial channels and are related to the business of the parties to the contract. These parties were subject to substantial economic risk, including risks related to delivery such as demurrage, damage, theft and deterioration.

On the other hand, exempt energy contracts may be entered into by "commercial participants who, in connection with their business activities incur risks, in addition to price risk, related to the underlying physical commodities." This sounds impressive, but a publicly offered commodity pool or a floor broker with a partial interest in a single oil well could, in good faith, claim that it met the risk portion of the commerciality test. Indeed, it could be argued that an entity could become a "commercial participant" for purposes of the exemption simply by entering into an exempt transaction. This is because the terms of an exempt energy contract expose the parties to the contract to the risk of owning the commodity. This circularity essentially nullifies the commerciality requirement of the energy exemptive order.

Related to the definition of commerciality is the capacity to make or take delivery under the contract. In the Brent Statutory Interpretation, the participants in Brent contracts were described as having the capacity to actually make or take delivery of cargoes of Brent crude oil. On the other hand, the Commission's energy exemptive order permits participants to contract out for delivery capacity and permits business entities that do not meet the net worth requirements of the order to participate in exempt energy contracts though guarantees provided by other business entities which meet the net worth requirement, <u>or</u> by a bank, savings association, insurance company, broker-dealer, futures commission merchant which are not required to meet any net worth requirement. Taken together, these provisions of the energy exemptive order describe a system virtually identical to that used by traders who trade on futures contracts with the benefit of a performance guarantee provided by their carrying futures commission merchant.

In my view, Brent contracts, as described in the Brent Statutory Interpretation, may well be futures contracts under the traditional criteria applied by the courts and the Commission. The

Commission's energy exemption is an expansion of the Brent Statutory Interpretation in markets covered, delivery alternatives permitted, market participants deemed appropriate, level of commerciality required and the type of delivery capacity needed. As a result, it is quite probable that many of these exempt transactions are, in fact, futures contracts within the meaning of that term developed by the Commission and the courts.

My conclusion that the energy order exempted futures contracts from the provisions of the Act reinforced my view that, as a general rule, the Commission should retain anti-fraud authority whenever it grants an exemption under Section 4(c). As I will explain, I was not convinced that, in the context of the energy exemptive order, the case had been made for making an exception to my strong preference that we retain anti-fraud authority in exemptions. As a result, I dissented from the Commission's order exempting energy transactions.

One of the primary arguments advanced for granting an exemption to the anti-fraud provisions of the Act has been that the participants in exempt energy transactions are "sophisticated" institutional users or entities of high net worth who do not "need" the anti-fraud protections of the Act. At the outset, I would note that if we are to rationalize exemptions from anti-fraud and other components of our regulatory scheme on the basis of the "sophistication" of market users, we might as well close our doors tomorrow, because approximately 98% of users of regulated, exchange-traded futures are also "sophisticated" institutional users or entities of high net worth. Moreover, the Commission has never recognized an exception to its jurisdiction based solely on the "sophistication" of market participant, nor can I see any policy reason why sophisticated firms should not be covered by basic anti-fraud provisions.

Additionally, we all know that large firms <u>are</u> defrauded. The Commission has brought or assisted in a number of actions where the victims have been so-called institutional or sophisticated investors. For example, with the Commission's assistance, the employee of a bank holding company was convicted of defrauding a number of banks in Pennsylvania in connection with their futures trading. Last summer, the Commission found that a regional brokerage firm had engaged in unauthorized trading of the account of a now-failed savings and loan with the assistance of an employee of the S&L.

Further, as I have described, the Commission's exemptive order permits participation in exempt energy transactions by comparatively low net worth individuals or small businesses, through the footnote permitting collective investment vehicle participation, the $1 million net worth threshold for corporations and proprietorships and the sweeping guarantee provision. The participation of such entities not only undermines the sophisticated institution argument for an exemption from the anti-fraud provisions of the Act for energy transactions it also increases the likelihood of exempt energy boilerrooms that target small business. Finally, because the order fails to expressly retain Section 4o authority, it is unclear if the Commission has the authority to sue a registered commodity pool operator for fraudulent representations to prospective pool investors concerning the pool's participation in exempt energy transactions.

For all of these reasons, I was unpersuaded that an exemption from the anti-fraud provisions of the Act could properly rest on the types of participants permitted to use exempt energy transactions.

Another argument made to justify an exemption from the anti-fraud provisions of the Act is that retaining these provisions would place an onerous burden on the energy markets. First, I must emphasize that if the anti-fraud provisions of the Act had been retained, they would only apply to fraudulent transactions. In order to prevail, our Division of Enforcement would have to show both that fraud occurred and that the transaction in question was a "futures contract" subject to the jurisdiction of the Act. In addition, participants in Brent contracts would still be able to brandish the Brent Statutory Interpretation as a shield against CFTC enforcement action because the energy exemptive order preserved the viability of that document.

It should also be emphasized that 4b and 4o apply no more of an onerous burden on these markets than does state anti-fraud law. Indeed, given conflicts in state law, providing federal forums and remedies in connection with these transactions is, if anything, less onerous than forcing participants, many of which are not U.S. companies, to resolve their disputes under state law.

Further, at least some of the energy contracts exempted by the Commission are subject to a foreign regulatory scheme that appears to be more onerous than retention of the anti-fraud provisions of the Act would be. For example, 15-day Brent contracts are considered "investment contracts" under the United Kingdom's Financial Services Act, a category of contracts that includes futures. The Financial Services Act contains limitations on the types of customers who can participate in non-exchange traded investment contracts, such as 15-day Brent contracts. The contracts are also subject to an Oil Market Code of Conduct promulgated by the Securities and Investment Board, a body which is empowered to enforce the Financial Services Act. The Oil Code of Conduct, among other things, prohibits the making of misleading statements and misleading conduct in connection with 15-day Brent contracts. The Oil Code of Conduct refers in this regard, to Section 47 of the Financial Services Act, violation of which constitutes a criminal offense punishable by up to 7 years imprisonment or a fine or both.

In these circumstances, I did not see that it was much of a burden on market participants to retain the anti-fraud provisions of the Commodity Exchange Act.

I have also heard the argument that federal anti-fraud remedies are unnecessary because state remedies remain available in the absence of the anti-fraud provisions of the Act. I simply do not view the existence of state anti-fraud remedies as a valid policy basis for providing an exemption from the Act's basic anti-fraud protections. It is important to remember that it was the historical inadequacy of state law protections that gave rise to federal regulation of financial markets, including the Commodity Exchange Act and the CFTC, in the first place. In view of these concerns, I was not persuaded that state remedies provided an adequate alternative to the anti-fraud provisions of the Act.

In addition, I could see no valid policy reason for distinguishing the Commission's retention of anti-fraud authority in the Commission's swaps rule from the failure to do so in the energy exemptive order. Both swaps and energy contracts are principal to principal contracts in which brokers are permitted to facilitate transactions. Both permit letters of credit and guarantees to substitute for net worth in determining the eligibility of some participants. In fact, the asset thresholds for eligible swap participants are significantly higher than those required of eligible energy contract participants. Because the energy exemptive order is broader than the swaps rule in allowing low net worth individuals and businesses qualify to participate in exempt transactions, the energy order would, if anything, seem to present an even stronger case for retaining anti-fraud protections than the swaps rule.

I also think that the Commission set a dangerous precedent in not retaining the anti-fraud provisions of the Act in the energy exemption. To my knowledge, it is unprecedented for the Commission to provide relief from anti-fraud provisions for a transaction that is not subject to the jurisdiction of another regulator. Even

Commission rules governing trade options, which are options offered to commercials in connection with commodities used in their business, are subject to an antifraud provision. Retention of anti-fraud jurisdiction is standard in exemptions granted by the Securities and Exchange Commission, even those that involve very high net worth investors. My fear is that the Commission has raised the expectations of other potential applicants for exemptive relief, including the futures exchanges, that they will also be able to escape Sections 4b and 4o. Remember, approximately 98% of users of regulated, exchange-traded futures are sophisticated institutional users or entities of high net worth.

Finally, I see the struggle over whether to retain anti-fraud authority over exempt energy contracts as a sign that the Commission is not yet taking full advantage of the flexibility provided by our broad exemptive authority. I find this very frustrating. The primary reason why the CFTC sought general exemptive authority during its reauthorization was to give us the flexibility to craft appropriately tailored exemptive relief based on public policy considerations, instead of continuing to deal with the "all or nothing" jurisdictional decisions that the Act required in the past. I see the energy exemptive order as evidence that we are still following this "all or nothing" approach when, in my view, we should be carefully weighing individual aspects of our regulatory structure and making a reasoned determination as to which requirements should and should not apply to a particular class of transactions.

Thank you.

Statement of Joseph B. Dial
Commissioner
Commodity Futures Trading Commission

Before the
Subcommittee on Environment, Credit and Rural Development
April 28, 1993

Concerning the exemptive order for certain energy contracts,
Approved by the Commission April 13, 1993

As I stated in my concurring opinion to the exemptive order relating to certain energy contracts, issued by the Commission on April 13, 1993, I believe that this exemption was unique, given its factual and legal background. In my comments on the 13th I expressed the belief that Congress intended to allow existing energy contract practices in these markets to continue to perform a useful function in the international marketplace. I noted my belief then, and respectfully submit to you today, that the Commission was exercising its exemptive authority in a manner consistent with Congressional intent.

From November 16, 1992 to April 13, 1993, I relied on the plain language of the Futures Trading Practices Act and the conferees' report as my guide in reaching a decision on the energy proposal. There are seven factors explicitly stated in the statute and conference report that I referred to time and time again:

1. The conference report to the Futures Trading Practices Act of 1992 (FTPA), in a paragraph in the exemptive authority section entitled "Forwards," specifically provided that "[T]he conferees encourage the Commission to review this situation and these contracts to determine whether exemptive or other action should be taken." (FTPA, at 82).

2. The conferees indicated that the exemptive authority should be used to "create legal certainty for a number of existing categories of instruments which trade today outside of the forum of a designated contract market." (FTPA, at 80)(emphasis added).

3. The conferees further stated that the Commission should use the exemptive authority promptly in the "areas where significant concerns of legal uncertainty have arisen," including, among others, forwards. (FTPA, at 81).

4. The conferees specifically did not express a view regarding the applicability of the Commission's Brent interpretation. (FTPA, at 82).

5. The conferees expressly stated that the exercise of this exemptive authority would not "require any determination before hand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act." (FTPA, at 82, 83).

6. The FTPA provides that the Commission may exempt an agreement, contract, or transaction from Section 4(a) of the Act, "or from any other provision of this Act (except section 2(a)(1)(B)), if the Commission determines that the exemption would be consistent with the public interest." (FTPA, Section 502)(emphasis added).

7. The Conferees stated that the public interest test should "include the national public interests noted in the Act, the prevention of fraud and the preservation of the financial integrity of markets, as well as the promotion of responsible economic or financial innovation and fair competition." (FTPA, at 78).

Given each of these factors, it remains my determination that the exemptive order as approved by the Commission was appropriate. The conferees chose to allow our prior Statutory Interpretation Concerning Forward Transactions, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) § 24,925 (September 25, 1990)(hereinafter referred to as the Brent Interpretation) to stand. Furthermore, the language of the conference report clearly states that CFTC does not have to find a contract within our jurisdiction in order to exempt it. Accordingly, I voted to provide the requested relief to existing "forwards-like" markets which could arguably come under the penumbra of the Brent interpretation, believing we should treat these more as "excluded forwards" than as "exempted futures." As such, I made the decision that the application of Section 4b to these contracts was inapposite.

I based this decision in part on my understanding of the legislative intent regarding regulation of forwards contracts. The Section 2(a)(1) exclusion for such contracts was grounded on the premise that "the Act's regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity." (Brent Interpretation, at 37,367). That interpretation described the Commission's determination as to what "commercial-to-commercial transactions involving commodities it considers to be within the scope of the Section 2(a)(1) exclusion." (Brent Interpretation, at 37,368). Included within that scope of exclusions are "transactions [which] create specific delivery obligations . . . [which] create substantial economic risk of a commercial nature to the parties . . . ." (Brent Interpretation, at 37,368).

I believe that the contracts which were the subject of the April 13, 1993 exemptive order were sufficiently within the penumbra of the Brent Interpretation so as to warrant similar treatment. These contracts are restricted to commercial entities, and create delivery obligations that entail market risk. Even though parties may enter subsequent contracts to discharge the obligations (for example, agreements akin to the cancellation agreements discussed in the Brent Interpretation), this does not nullify the market risks attendant to these transactions. Similarly, even though the parties may satisfy the capacity requirement of the exemption by executing bona fide contracts for services such as production, refining, or storage, this still requires the ability to bear market risks involved with the transactions.

Accordingly, I believe that the exemptive authority sufficiently delimited the relief to existing markets which come within the general category specified in the conference report paragraph noted above, entitled "Forwards." This, I believe, indicates that the fraud protection available to current participants in the forwards market is sufficient for contracts included in the exemptive order, and renders the application of Section 4b inappropriate. I took this into account in reviewing the various components of the public interest test, and I came to the decision to support the energy exemption order as it was approved after carefully reviewing the nature of the relief requested, the existing markets, the above-mentioned directives of the conference report and the statute.

April 9, 1993

MEMORANDUM

TO: Files

FROM: Andrea M. Corcoran
Division of Trading and Markets

RE: Exemption for Certain Contracts in Energy Products

This memorandum sets out reservations, which I have shared with each Commissioner, concerning the draft Order that exempts certain contracts from most provisions of the Commodity Exchange Act--in particular, the anti-fraud provisions.[1]

The new flexibility afforded the Commission by the Futures Trading Practices Act of 1992 provides welcome relief from the need to make "all or nothing" decisions on the legality of products subject to our jurisdiction. The opportunity to reduce current restraints on commerce and to permit markets to evolve, however, does not alter the Commission's overriding responsibility to protect the public interest.

As drafted, the exemption covers certain collective investment vehicles and permits speculative transactions as well as transactions based upon commercial need. The retail public who might participate in such entities would be unlikely, absent the blandishments of the salesman, to enter speculative transactions in energy prices. Similarly, small commercials would be unlikely to enter such transactions in the ordinary course of their businesses.[2]

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[1] I have signed the draft as consulted on behalf of the Division of Trading and Markets, and many of my suggestions have been incorporated. Ultimately, however, policy concerns are committed to Commission discretion.

[2] Among the public policy implications of developments that the Commission is asked to specifically study and report on to Congress at the end of fiscal 1993 are those resulting from the case of Krommenhoeck v. A-Mark Precious Metals, Inc., 945 F.2d 309 (9th Cir. 1991). That case, by reference to the so-called *Brent Statutory Interpretation Concerning Forward Transactions* (55 F.R. 39188) found certain contracts to be both futures and forward contracts and denied the relief sought with respect to substantial losses suffered by small commercial customers. Conference Report to accompany H.R. 707, H.R. Rep. No. 102-978, 102 Cong. 2d Sess. at 83.

To my knowledge, the Commission has never before exempted transactions in products subject to its jurisdiction from the anti-fraud provisions of the Act unless another regulatory regime clearly applied to such transactions.[3] In this case, energy contracts exempted from the CEA would also be exempt from state anti-bucketing laws and, to the extent that they are not investment contracts or securities, or can be so designed, they would be exempt from the securities laws as well.

By way of comparison, transactions in exempt securities--including transactions by sophisticated investors (such as qualified institutional participants with $100,000,000 portfolios) are not exempt from the anti-fraud provisions of the federal securities laws.[4] Further, in the United Kingdom, certain transactions in the Brent Oil market itself are subject to the criminal anti-fraud provisions of the Financial Services Act (Section 47 (1)) and small commercial counterparties are generally limited by law to transactions integral to their businesses.[5]

By retaining anti-fraud jurisdiction to the extent applicable, the Commission no more suggests that exempted energy contracts may be futures (rather than forward) contracts than it does by expressly acknowledging in the proposed release that the Commission is not making a determination that these contracts are not subject to the CEA or than the applicants have by requesting an exemptive order from the exchange trading requirement for futures.[6]

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[3]Compare the treatment of swaps (anti-fraud provisions retained) with the treatment of hybrid securities or depository instruments (anti-fraud provisions relinquished in deference to applicable federal and state securities and banking laws) in the Commission's new Part 35 Rules.

[4]See _e.g._, Section 10b of the Securities and Exchange Act of 1934 and Rule 10b-5; see also Preliminary Note i to Rule 144A). Also, as the result of failures of certain secondary dealers, aspects of the government securities markets were regulated in 1986 and further regulation is contemplated as a result of the alleged Salomon Brothers manipulation.

[5]See Appendix 2, Oil Market Code of Conduct of the Securities and Futures Authority (SFA) Rule Book and SFA Conduct of Business Rule 5-5.

[6] See Division of Enforcement memorandum, dated April 8, 1993, to Gerry Gay concerning the scope of Section 4b. I would make just one other point. Among the list of qualified counterparties are certain entities which meet a net worth ($1,000,000) or a net assets ($5,000,000) test. The exemption makes clear however that a guarantee of no specified amount can be substituted for this minimum size and resources test and potentially for the capacity to deliver. To the extent this provision is included to permit participation by small commercials in energy-related businesses it is unnecessary - another provision does so. Separately, participation on organized futures exchanges is largely commercial, and intermediary guarantees and clearing guarantees substitute for the credit judgments made in private transactions betweeen counterparties as principals.

Commodity Futures Trading Commission Implementation of
The Futures Trading Practices Act of 1992

	SUBJECT	COMMISSION ACTION	TIMETABLE (Statutory)
1.	Exemptive Authority-Swaps	Final Rule (58 FR 5587, 1/22/93)	Promptly
2.	Exemptive Authority-Hybrids	Final Rule (58 FR 5580, 1/22/93)	Promptly
3.	Exemptive Authority-Forwards	Final Order (58 FR 21286, 4/20/93)	Promptly
4.	Dual Trading	Proposed Rules (58 FR 13025, 3/9/93)	270 Days
5.	Broker Associations	Proposed Rules (57 FR 57116, 12/3/92)	270 Days
6.	Floor Trader Registration	Final Rules (58 FR 19575, 4/15/93)	180 Days
7.	Ethics Training	Final Rules (58 FR 19575, 4/15/93)	180 Days
8.	Reparations/Class Actions	Proposed Rules (58 FR 17369, 4/2/93)	270 Days
9.	Telemarketing	NFA Rule 2-9 approved 1/19/93	180 Days
10.	Insider Trading		360 Days
11.	Exchange Emergency Actions	Final Rule adopted 4/26/93	180 Days
12.	Margin	Federal Reserve Board delegation to CFTC	None
13.	Derivatives Study		One Year
14.	Risk Assessment		Two Years
15.	Suspension of Registrants Charged with Felonies	Final Rules (58 FR 19575, 4/15/93)	None
16.	Conflicts of Interest		None
17.	SRO Governing Boards/Disciplinary Committees	Proposed Rules (58 FR 13565, 3/12/93)	270 Days
18.	Audit Trail		Two Years
19.	Penalty Study		Two Years
20.	Computerized Trading Study		Two Years
21.	Competitiveness Study		18 Months
22.	Oral Orders	Proposed Rules (57 FR 62244, 12/30/92)	270 Days

AMEND THE COMMODITY EXCHANGE ACT TO ENSURE THE CONTINUED APPLICATION OF THE ACT'S ANTIFRAUD AND ANTIMANIPULATION PROTECTIONS

WEDNESDAY, JUNE 30, 1993

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ENVIRONMENT, CREDIT,
AND RURAL DEVELOPMENT,
COMMITTEE ON AGRICULTURE,
Washington, DC.

The subcommittee met, pursuant to call, at 10:15 a.m., in room 1302, Longworth House Office Building, Hon. Glenn English (chairman of the subcommittee) presiding.

Present: Representatives Long, Clayton, Barlow, Holden, McKinney, Penny, Sarpalius, Peterson, Baesler, Farr, Gunderson, Allard, Nussle, and Smith of Michigan.

Staff present: Vernie Hubert, chief counsel and legislative director; Fred Clark, deputy chief counsel; John E. Hogan, minority counsel; John Frank, deputy minority counsel; Glenda L. Temple, clerk; Benjamin I. Baker, James E. McDonald, James A. Davis, John Riley, and David Ebersole.

OPENING STATEMENT OF HON. GLENN ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. ENGLISH. The hearing will come to order. A couple of months ago this subcommittee held a hearing with regard to action that was taken by the CFTC regarding the exemption of certain instruments from the antifraud and antimanipulation provisions of the Commodity Exchange Act.

While there is a question that remains as to whether or not there is jurisdiction as far as the CFTC is concerned in some of these areas, we felt that it was questionable as to the wisdom of giving blanket exemptions on any authority that it may have.

So with that in mind, we have a hearing today with regard to legislation to reinstate those provisions of antifraud and antimanipulation protection. The legislation before us is H.R. 2374 and we have three witnesses today. We have Mr. Patrick Arbor, who is chairman of the Chicago Board of Trade.

We would ask that he be our first witness today.

Let me also ask, is there any member who has an opening statement that they would care to make this morning before we hear from our first witness?

And for the record, although Mr. Donovan is well-known, we will let you introduce Mr. Donovan if he is accompanying you.

Also, any prepared statements submitted by the members will appear at this point in the record.

[The prepared statements of Mr. Farr, Mr. Combest, H.R. 2374, and report from the Commodity Futures Trading Commission follow:]

STATEMENT OF THE HONORABLE SAM FARR
UPON THE HEARING AND CONSIDERATION OF H.R. 2374
IN THE SUBCOMMITTEE ON ENVIRONMENT, CREDIT AND RURAL DEVELOPMENT
JUNE 30, 1993

Mr. Chairman and my fellow colleagues, it is a pleasure to join you today for my first hearing and business meeting as the newest member of the House Agriculture Subcommittee on Environment, Credit and Rural Development. I want to thank you for allowing me the opportunity to join you in working on issues of great importance to the American farm economy.

The 17th District of California includes some of the most bountiful farmland in the country and one of the most beautiful coast lines in the world. My work in the California State Assembly included protection of that beautiful coastal environment. As I continue my work in this area, I look forward to my new tasks ahead as a federal representative serving the people who provide the largest economic base in my district, farmers.

In a world of diminished resources, international trade agreements and banking reform, I know that the challenges the Subcommittee face are great. I look forward to working with each of you on formulating policy that benefits all farmers and Americans in this country.

Thank you.

Statement of
the Honorable Larry Combest, M.C.
Subcommittee on Environment, Credit and Rural Development
Committee on Agriculture
June 30, 1993

Mr. Chairman, the hearing we had on April 28th convinced me that the matter of CFTC exemptive authority was going to be a contentious issue. It was unfortunate, but not surprising, that the three committees of jurisdiction in the House could not resolve all the underlying issues last year during reauthorization of the Commission.

I note that our Committee has now received letters from the other two committees concerned about H.R. 2374. Although I say this half in jest, I am beginning to think we might have caused less harm had we simply moved forward with your proposal to define a futures contract. Markets in exchange-traded and derivative products have become so intertwined that the current, confused regulatory scheme is truly baffling to all but a few commodity lawyers. I assume we are going to hear from some of them this morning. So I hope to be enlightened.

While I understand your frustrations over this issue, Mr. Chairman, I did not hear April 28th nor have I heard anything since then that convinces me that this energy contract exemption could cause the defrauding of an innocent public. I understand there are plenty of innovative and unscrupulous people out there who may make me change my mind. But, even if such activity takes place the Commission's enforcement chief recognizes the obstacles the CFTC would face in bringing a case under the anti-fraud provisions of the Act. I assume when the CFTC deals with fraudulent boilerrooms, the Commission must first prove the contracts are illegal futures.

We certainly need to resolve these issues, and I look forward to working with you in the months ahead once the various studies are in and we have heard from the experts. In the meantime, it would be helpful if we could get a full complement of Commissioners and a chairman that has the confidence of the current Administration and congressional committees of jurisdiction.

72-584 O - 93 - 4

103D CONGRESS
1ST SESSION

H. R. 2374

To amend the Commodity Exchange Act to ensure the continued application of the Act's anti-fraud and anti-manipulation protections.

IN THE HOUSE OF REPRESENTATIVES

JUNE 10, 1993

Mr. ENGLISH of Oklahoma introduced the following bill; which was referred to the Committee on Agriculture

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A BILL

To amend the Commodity Exchange Act to ensure the continued application of the Act's anti-fraud and anti-manipulation protections.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. FUTURES ANTI-FRAUD PROTECTIONS.

The Commodity Exchange Act (7 U.S.C. 1, et seq.) is amended by adding at the end the following new section:

"SEC. 23. RETENTION OF CERTAIN AUTHORITIES.

"(a) IN GENERAL.—Except as provided in subsection (b), to the extent that the Commission, by rule, regulation, or order grants, or has granted, any exemption under section 4(c)(1) for any agreement, contract, or transaction (or class thereof), including an exemption for any person or class of persons offering, entering into, rendering advice or rendering other services with respect to the agreement, contract or transaction, from any of the provisions of this Act, such exemption shall not apply to the anti-fraud or anti-manipulation provisions of this Act.

"(b) EXCEPTION.—The proscription in subsection (a) with respect to the anti-fraud provisions of this Act shall not apply to an exemption for any agreement, contract, transaction, or person (or class thereof) to the extent that such agreement, contract, transaction, or person (or class thereof) is or will be subject to Federal securities or banking laws that provide comparable anti-fraud protection, as determined by the Commission.".

SEC. 2. REGULATIONS.

The Commodity Futures Trading Commission shall issue interim final regulations to implement the amendments made by section 1 of this Act within sixty days following the date of the enactment of this Act. Such interim final regulations shall include such amendments to any rule, regulation, or order previously issued by the Commission as necessary to comply with the amendments made by this Act.

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N. W., Washington, DC 20581

William P. Albrecht
Acting Chairman

(202) 254 - 6970

August 12, 1993

The Honorable E (Kika) de la Garza
Chairman, Committee on Agriculture
U.S. House of Representatives
1301 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This is in response to your letter dated June 14, 1993 requesting the Commission's views on H.R. 2374, a bill to amend the Commodity Exchange Act to ensure the continued application of the Act's anti-fraud and anti-manipulation protections to exemptions issued by the Commission under Section 4(c) of the Act.

Please find attached the individual statements of myself and Commissioners Bair and Dial setting forth our views on this bill as presented to the Subcommittee on Environment, Credit and Rural Development at its markup on June 20, 1993.

In your letter you ask us to include the cost of enacting this legislation for the current and next five fiscal years. This is difficult to do without further indication of Congressional intent. The bill would require the Commission to reserve the antifraud and manipulation provisions of the Act in each exemptive order the Commission has issued and will issue in the future under section 4(c) of the Act. If the intent of the legislation is not to expand the Commission's pre-existing enforcement authority, we believe our existing enforcement capability would be adequate to deal with these cases and there should not be any significant cost increases in enacting this legislation. If, on the other hand, the intent of the bill is that the Commission develop an active oversight and surveillance presence in markets where none has previously existed, significant additional staff and resources will be required.

We appreciate this opportunity to present our views to the Committee.

Sincerely,

William P. Albrecht

William P. Albrecht
Acting Chairman

Statement of Dr. William P. Albrecht
Acting Chairman
Commodity Futures Trading Commission
Subcommittee on Environment, Credit and Rural Development
Committee on Agriculture
U.S. House of Representatives
June 30, 1993

Mr. Chairman, I welcome this opportunity to submit my views to you and members of the Subcommittee on H.R. 2374, a bill which would prohibit the Commodity Futures Trading Commission from exempting any transactions from the anti-fraud and anti-manipulation provisions of the Commodity Exchange Act ("CEA"), except where the exempted transactions were determined to be subject to comparable anti-fraud jurisdiction under the Federal securities or banking laws. While I support the goals of preventing fraud and manipulation, I cannot support this legislation which would restrict the flexibility just recently granted to the CFTC. The need for this legislation has not been shown. In my view, it would not significantly increase protection from fraud and manipulation. And, despite its worthy goals, it could actually cause harm. Therefore, I urge you to proceed cautiously so as to preserve the great strides made in the Futures Trading Practices Act of 1992 ("FTPA") after years of consideration in Congress.

Anti-Fraud Need has Not Been Shown

I continue to believe the Commission has exercised its exemptive authority prudently without exposing the public to increased risk of fraud or manipulation. Nevertheless, I recognize your disagreement with the Commission's decision to exempt certain energy contracts from the anti-fraud provisions of Section 4b of the CEA as you forcefully expressed at your April 28, 1993 Subcommittee hearing. Certainly, it is legitimate to express concerns about the possibility that the Commission's action opened the door to fraud; however, I do not believe that we have done so. Nevertheless, the possibility, prevention and prosecution of fraud are issues that should be addressed.

With regard to the exempt energy contracts, the Commission carefully considered whether or not to exempt this market from the anti-fraud provisions of the CEA. Energy market participants had not asked the Commission for enforcement assistance before the exemption was granted, and I know of no problems since the exemption was granted.

The possibility of fraud was not ignored. In fact, one of the reasons the energy exemption was limited to commercial, principal-to-principal transactions was to protect the public from potential boiler rooms. It is hard to imagine any boiler room style operation dealing with the public which would not violate the terms of the exemption and thus be subject to the full coverage of the CEA, to the extent it applied, including its anti-fraud provisions and its prohibition against off-exchange trading.

In the unlikely event that some unanticipated fraudulent practices violating Section 4b within the scope of the energy exemption occur, the Commission is not left without alternatives. Obviously, the Commission could amend the exemptive order to assert Section 4b authority over the exempt transactions (again, to the extent it applied). Or even better, it could amend the exemptive order to leave the questionable transactions outside the scope of the exemption altogether. In such a case the Commission would not need to prove fraud, rather it need only show that the transactions were futures contracts not conducted on a designated exchange and are thus illegal.

Finally, in addressing the need for CFTC anti-fraud jurisdiction, the alternative laws available to police a given market should be considered. Indeed, H.R. 2374 recognizes that CFTC fraud jurisdiction is not necessary when comparable securities or banking anti-fraud laws exist. In my view, given the apparent absence of fraud in these transactions, existing criminal and civil remedies are adequate to police these energy market transactions.

<u>No Significant Benefits from Additional Anti-Fraud Law</u>

Protecting market participants from fraud is of the highest importance to the CFTC, as it should be to any regulator. In the exempt energy contracts, there were significant legal and practical obstacles that more than offset any potential benefits of extending Section 4b coverage to those contracts.

The initial obstacle to the application of Section 4b was that Section 4b applies only to futures contracts and the vast majority of the energy contracts in question appeared to be forward contracts under the Commission's 1990 <u>Statutory Interpretation Concerning Forward Transactions</u>. In addition, by its own terms, the coverage of Section 4b is limited to fraud committed by one person acting for or on behalf of another. Thus, Section 4b apparently does not apply to the principal-to-principal energy contracts in question.

Besides the legal obstacles to the application of Section 4b there was the very real practical problem that retaining Section 4b would have injected an illusion of Commission supervision into a market where there was no ongoing regulation. Effective use of Section 4b may require an ongoing CFTC regulatory presence which would have created other problems. After all, for the instruments it regulates the Commission maintains comprehensive regulatory programs utilizing not only regulations and direct enforcement, but also oversight of extensive programs of more than a dozen self-regulatory organizations (SROs). To credibly maintain anti-fraud jurisdiction over exempt transactions the Commission may believe that it is obligated to exert at least a modified regulatory presence. Finally, the Commission just does not have the resources necessary to extend its regulation to all these markets.

Real Burdens

In my April 28, 1993 testimony before this Subcommittee I expressed my concerns that retaining Section 4b would do more harm than good. Rather than providing a potential benefit, it would create legal uncertainty. I was concerned that, after having gone to great lengths to assure foreign energy firms that they may engage in the normal business practices that existed prior to the district court decision in Transnor (Bermuda) Limited v. BP North America Petroleum, 738 F. Supp. 1472 (S.D.N.Y.) ("Transnor"), the presence of Section 4b may say to some that the futures issue is not over. To some of these firms the mere presence of Section 4b would have indicated that the CFTC is exerting some jurisdiction over them and that more may follow. This was not an unreasonable view given that the Commission had never regulated, nor sought to regulate, this market and that the market was not then viewed as being within the scope of Section 4b. The legal uncertainty as to whether the CFTC would in some way regulate these energy markets was reported to inhibit the ability of U.S. firms to engage in international oil trading.

Even if there is disagreement on whether the Commission has acted appropriately in a given situation, elimination of Commission flexibility would in itself have adverse consequences. Flexibility is needed to deal with the innovations and problems of tomorrow which we cannot predict today. It is that need for flexibility to enable the Commission to allow, even encourage future innovations, that was the driving force behind Congress' grant of exemptive authority just last year.

Exemptive Authority

In my view it is very important that H.R. 2374 be considered in the context of the grant of exemptive authority to the Commission in the FTPA. In my April 28, 1993 statement submitted to you I noted the advent of new financial instruments in recent years which contain both futures and non-futures elements. Analysis of these new financial instruments placed the Commission in the jurisdictional dilemma of either forswearing any jurisdiction at all over the instrument in question or requiring that it be traded on a designated exchange. This dilemma faced by the Commission in turn caused great legal uncertainty for the parties to transactions referred to as "swaps", "hybrids", and "cash settled" forwards, and other commodity linked instruments which had futures-like characteristics.

The threat of legal uncertainty was highlighted by the district court decision in Transnor: parties to transactions that had never before been considered futures contracts now faced the prospect of having their transactions ruled void as off-exchange futures contracts. The Commission responded to provide legal certainty to "Brent" market participants and to parties to similar transactions, regardless of location or underlying commodity, by issuing a statutory interpretation stating that the CFTC did not view these transactions as futures, but rather as cash forward contracts, and thus excluded from regulation under the CEA. Regretfully, this did not completely resolve the problem and reportedly some international firms continued to refuse to do business with United States based firms.

Fortunately, Congress was aware of the severe problems caused by the legal uncertainty facing not only Brent market participants, but all parties to these new financial instruments with futures-like characteristics. Congress recognized the need to provide flexibility in this area and in the FTPA authorized the Commission to exempt any agreement from the exchange-trading and most provisions of the CEA contingent upon certain conditions. Those conditions include Commission determinations that the exemption is in the public interest, that the agreement is between appropriate persons (such as institutional participants), and that the agreement does not have a material adverse effect on the ability of the Commission or any exchange to discharge its regulatory or self-regulatory duties. Granting the Commission this exemptive authority was one of the most significant amendments to the CEA by Congress in recent years.

As you know, there is no statutory definition of a futures contract. The legal definitions relied on today largely come from Commission enforcement actions against boiler room operations. The problems caused by application of those same definitions to legitimate instruments with futures-like characteristics were one of the reasons exemptive authority was needed.

One of the wisest decisions made by Congress in granting the Commission exemptive authority was that exemptions do not depend on a determination that exempt transactions are futures contracts. Some strongly disagree with the notion that the Commission can exempt transactions not within its jurisdiction. I appreciate the rationale of this position, but it ignores the history of why the exemption was necessary in the first place. The exemptive authority was necessary because a whole new generation of instruments has evolved that no longer clearly fit into the traditional regulatory categories.

Swaps are an excellent example of the need for legal certainty and the need for a broad exemption. Swaps are limited to appropriate participants and serve the legitimate financial management needs of firms all over the world, and yet many would say that economically they are the equivalent of futures contracts traded on exchanges. Without Congress' actions in the FTPA and the Commission's exemption, this entire market could be upset by a future Transnor-like decision. Fortunately, Congress did not require the Commission to decide whether swaps generally, or whether any swaps in particular, were futures contracts before granting the exemption. As you consider H.R. 2374 I urge you to recognize the need to provide the Commission with exemptive authority which is sufficiently broad to foster the necessary degree of legal certainty for any particular market--including markets that cannot be anticipated today. Only by doing so will Congress foster innovation in the manner that I understood was the intent of the FTPA.

Manipulation

The concerns raised about eliminating Commission flexibility with regard to anti-fraud jurisdiction also apply to manipulation jurisdiction. There does not appear to be a need for retaining this authority, there will not be significant benefits gained by retaining it generally and there are very real burdens to be placed on the exempt markets. In the case of swaps, hybrids and energy contracts, the Commission retained limited anti-manipulation authority. For instance, under the swaps exemption the Commission can take action against a swaps dealer for using swaps contracts to manipulate the futures market, or the underlying cash market, but the Commission did not retain the authority to take action against a swaps dealer for manipulating the swaps market. After all, swaps are less susceptible to manipulation since they are cash settled without a common expiration. The Commission maintains an extensive surveillance and reporting program in conjunction with the SROs designed to address manipulation problems well before they are allowed to develop. The Commission does not have such programs in place in the swaps market. Arguably some such program would be needed to exercise anti-manipulation authority in the swaps market itself.

Overlapping Jurisdiction

I appreciate the fact that one of the goals of H.R. 2374 is to coordinate the coverage of Federal commodities law with Federal securities law and Federal banking law. While I agree that the CFTC should consider comparable anti-fraud provisions in Federal securities and banking laws, those are not the only sources of anti-fraud laws. For example, criminal laws enforced by the Department of Justice, including wire and mail fraud statutes, are frequently used in commodities fraud cases, even where the CEA is also applicable. Additionally, state laws may in themselves be sufficient to police some markets.

Before concluding, I would like to comment on the legitimate interest of the states in seeking to protect their citizens from fraud. I am confident that the Commission will continue to assist the states in their efforts to protect their citizens. Further, I look forward to continued dialogue with state regulators that will foster effective enforcement.

In conclusion, while I cannot support H.R. 2374, I appreciate the opportunity to discuss my views. I trust that full consideration of this legislation will clarify Congressional intent on the scope of the Commission's exemptive authority.

Statement of Sheila C. Bair
Commissioner
Commodity Futures Trading Commission

Before the House of Representatives Committee on Agriculture
Subcommittee on Environment, Credit
and Rural Development
June 30, 1993

Mr. Chairman, members of the Subcommittee. Thank you for the opportunity to appear before you today to discuss H.R. 2374. I am pleased to express my support for this legislation, which is designed to ensure that the anti-fraud and anti-manipulation provisions of the Commodity Exchange Act will remain applicable to transactions exempted by the Commission from other provisions of the Act. I believe that the anti-fraud and anti-manipulation provisions of the Act are basic and central to our regulatory scheme. My views in this regard are set out in more detail in my testimony presented before this Subcommittee on April 28, 1993. I only regret that legislation which limits the Commission's exemptive authority appears to be necessary to maintain the applicability of these provisions of the Act.

I agree with the approach of H.R. 2374 as to when the Commission should retain the anti-fraud and anti-manipulation provisions of the Act and when sound public policy considerations indicate that -- in very limited circumstances -- an exemption from the anti-fraud provisions of the Act is appropriate. Consistent with H.R. 2374, the only circumstance in which I believe that an exemption from the anti-fraud provisions of the Act would be proper is when the transactions or persons exempted are subject to the jurisdiction of the SEC or the federal banking regulators.

One issue which the Subcommittee may wish to consider is whether the bill should identify the specific sections of the Act that comprise the Act's anti-fraud and anti-manipulation provisions. The failure to specify which provisions of the Act the Commission must retain when it grants an exemption may lead to further misunderstandings between the Commission and the Subcommittee.

Alternatively, the bill could direct the Commission to draft and adopt special anti-fraud and anti-manipulation rules of general applicability to all exempted instruments. This is the approach the Commission has followed under its plenary authority over options in retaining anti-fraud authority over exempted trade options. See, Commission Rule 32.9, 17 C.F.R. § 32.9. Such rules could apply across the board to all transactions exempted from the Act by the Commission. Such an approach would uniformly preserve the Commission's ability to put a stop to fraudulent activities involving futures transactions, regardless of whether the transactions fall within the parameters of an exemption the Commission has granted.

Adoption of general anti-fraud and anti-manipulation rules for exempted instruments and persons would put all applicants for an exemption on notice that these crucial requirements will not be waived. This approach would free the Commission to make a reasoned determination about which aspects of our regulatory structure should continue to apply to an instrument or activity for which an exemption is sought without wasting time and energy debating the advisability of preserving anti-fraud authority in a particular case.

As previously stated, I think it is appropriate that the legislation gives the Commission the flexibility to grant exemptions from the anti-fraud provisions of the Act where it determines that the relevant transaction is subject to the Federal securities or banking laws. This is a determination that the Commission is competent to make. However, once the Commission has determined that a particular transaction is subject to a sister regulator's jurisdiction, this should be sufficient. It is unnecessary, to my mind, to further require a determination as to whether the other regulator's anti-fraud protections are "comparable." For this reason, I suggest that this concept be stricken from H.R. 2374.

Although I have referenced a few technical concerns in my testimony which the Subcommittee may wish to consider, overall, I believe that H.R. 2374 will achieve the important goal of ensuring that the anti-fraud and anti-manipulation protections of the Act continue to apply to transactions exempted by the Commission from other regulatory requirements. Preserving such authority in no way implies that particular types of exempted off-exchange transactions such as traditional swaps or 15 day Brent Oil contracts are in fact futures contracts subject to CFTC jurisdiction. On the contrary, it simply reflects the difficulties in crafting exemptive relief broad enough to accommodate the legitimate needs of existing OTC markets without providing a loophole for those who might try to use an exemption as a shield against CFTC enforcement actions. Preserving anti-fraud and anti-manipulation authority will ensure that the CFTC continues to have the tools it needs to protect the public interest.

Statement of Joseph B. Dial

Commissioner
Commodity Futures Trading Commission

Before the House of Representatives Committee on Agriculture

Subcommittee on Environment, Credit,
and Rural Development

June 30, 1993

Thank you for the opportunity to comment on H.R. 2374. I will not reprise my comments of April 28, 1993, on this subject, inasmuch as they are a matter of record and I have not altered my position.

If Congress passes H.R. 2374, then I will do all that is within my power as a Commissioner to see to it that Commodity Futures Trading Commission (CFTC) complies with the provisions of this legislation. However, I respectfully submit my considered opinion on the consequences of passage of H.R. 2374.

First, the intent of Congress in passing the Futures Trading Practices Act (FTPA) of 1992, as expressed by the conferees, is that, among other provisions, the Commission should use the exemptive authority promptly in the "areas where significant concerns of legal uncertainty have arisen," including, among others, forwards. (FTPA, at 81).

If passed, H.R. 2374 will remove the legal certainty that the CFTC exemptive order provides, because H.R. 2374 will apply a futures antifraud provision to forward contract circumstances. If H.R. 2374 becomes law, the energy sector will be right back where they were after the court handed down the Transnor decision and CFTC subsequently issued its Brent Oil Interpretation. H.R. 2374 will put a cloud of legal uncertainty over the head of energy industry participants who wish to use these forward contracts without assuming the legal risks of trading legally ambiguous contracts which would expose them to an inappropriate regulatory scheme.

If Congress decides to pass H. R. 2374 and do a 180-degree turn from the position it took in the 1992 FTPA, that is their prerogative. The members should know, before they make such a move, that their action will impact the free market characteristic of business participation based on economic incentive. As a result, the cost of doing business in energy products may well increase and ultimately the taxpayer will have to foot the bill for unnecessary government intervention.

Forward contracts have been used in the normal course of commerce for a century. There is absolutely no historical evidence to prove that these transactional instruments have been a convenient ruse used by devious charlatans to defraud "mom and pop" retail customers. As of this date, no one has put forth a plausible scenario whereby the exempted energy contracts would subject the public interest to fraudulent schemes.

Granted, there are those who ascribe to the theory that this exemption will allow for general public participation through the use of pools, trusts, or partnerships, and the CFTC would not be able to use the 4b fraud provision to prosecute fraudulent activity in these circumstances. That is not the case.

In order for a collective investment vehicle to qualify for this exemption, it must satisfy all of the appropriate person requirements. Also, it can't be formed solely for the purpose of qualifying for the exemption. If <u>any</u> of these requirements are not met, the exemption is not applicable, and Section 4b fraud authority could be available. In addition, the exemption provides that Section 4o will continue to apply to commodity pool operator fraud.

It is important to understand that the appropriate person language in the CFTC energy exemption requires business proprietors to have a net worth of $1,000,000 or total assets exceeding $5,000,000, in order to become an eligible participant. Furthermore, only commercial entities are allowed to engage in the transactions covered by the energy exemption. As has always been the case, if any commercial entity, large or small, is victimized by fraudulent forward contract activity by its commercial counterparty, then the plaintiff may address such conduct through state law remedies. Accordingly, state fraud remedies clearly are available to participants involved in exempted energy transactions. Commodity Exchange Act (CEA) remedies are inappropriate, because Congress has excluded forward contract activity from CEA jurisdiction.

As further evidence of this fact, consider that in the 1992 FTPA, the conferees specifically did not express a view regarding the applicability of the Commission's Brent interpretation. (FTPA, at 82). Also, the conferees expressly stated that the exercise of this exemptive authority would not "require any determination beforehand that the agreement, instrument, or transaction for which an exemption is sought is subject to the Act." (FTPA, at 82, 83). Taken together, these two actions continue to position the forwards markets in the same light as CFTC viewed them, i.e., as being excluded from the Commission's jurisdiction. Consequently, CFTC cannot apply 4b, a futures regulatory provision, to exempted energy forwards.

If H.R. 2374 is enacted, then participants in exempted energy contracts will run the risk of a disgruntled counterparty having the option of reneging on its obligations by declaring an exempt forward transaction to be an illegal off-exchange futures contract, and having the panoply of futures market regulation applied to them. This clearly is not what Congress intended to happen when it passed the Futures Trading Practices Act of 1992.

STATEMENT OF PATRICK H. ARBOR, CHAIRMAN, CHICAGO BOARD OF TRADE, ACCOMPANIED BY THOMAS R. DONOVAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AND MARK YOUNG, COUNSEL, KIRKLAND & ELLIS

Mr. ARBOR. Thank you, Mr. Chairman, and members of the subcommittee. My name is Patrick Arbor and I am the chairman of the Chicago Board of Trade. I am accompanied, as you noted, Mr. Chairman, by Thomas Donovan, the president and CEO of the Chicago Board of Trade, and Mark Young with the firm of Kirkland & Ellis, who is our legal counsel.

Thank you for your invitation to present the views of the Chicago Board of Trade on H.R. 2374 and the exemptions the Commodity Futures Trading Commission has granted. As set out in my written testimony, the board of trade generally supports H.R. 2374.

Antifraud and antimanipulation are core protections that should apply to every transaction under the Commodity Exchange Act. We have suggested certain technical changes to H.R. 2374 to strengthen its provisions, but I am a businessman, not a lawyer, and rather than discuss those technical issues today, I would be happy to make our staff available to the subcommittee.

Mr. Chairman, like others, the board of trade could have just submitted our written views to you. We chose, however, to appear in person today to underscore our profound disappointment with the CFTC's exercise of its exemptive powers.

The issue is very simple. In granting the CFTC exemptive powers, Congress told the CFTC, "to promote fair competition." That is a quote from the statute. Congress told the CFTC to apply its exemptive powers in, "A fair and evenhanded manner to products and systems sponsored by the exchanges and nonexchanges alike."

Congress told the CFTC to use, "The least anticompetitive means of exempting persons or transactions from the provisions of the act." These are all quotes from the act.

Some 8 months have passed since the legislation became law. In that time, the CFTC has ignored those congressional mandates. The CFTC has refused to allow the exchanges to offer exempt instruments, swaps, energy contracts, under the same class of exemptive relief it has willingly provided to the dealer markets.

The result of these policies is the worst kind of unfair competition. Over-the-counter dealer trading is exempt from regulation, but exchange trading is subject to ever increasing regulatory cost and restrictions. If the trend continues, exchanges will not survive. They will lose the competitive battle to the over-the-counter markets and to foreign exchanges that enjoy nurturing relationships with their regulators.

Indeed, we have done some work in Chicago and have discovered that a customer opening up an account in the United States may have to sign as many as 20 different documents, suitability requirements, disclosure requirements. A same customer opening up an account in London or Paris may only have to sign two documents. The documentation, the compliance, is becoming just too onerous.

But let me be clear, Mr. Chairman. The board of trade does not want the over-the-counter market to be regulated beyond the fraud and manipulation protections that your bill would impose. We are comfortable with that. That kind of regulation is quite adequate for professional markets where the only traders are sophisticated parties who can protect themselves, but exchanges should have the opportunity to offer exempt professional markets too.

The CFTC to date has denied us that opportunity. The CFTC's policy also precludes clearing of exempt instruments, a process that we feel would strengthen the financial integrity of over-the-counter derivatives; indeed, many feel this. This is possibly the most bizarre aspect of the CFTC's policy.

Consider this: Since 1976 the CFTC has found that clearing is essential for any new futures or options contract. Without clearing, the CFTC has said it would disapprove trading, "As contrary to the public interest."

For exempt instruments, however, the CFTC has prohibited clearing and says that prohibition is, "Consistent with public interest."

Now, maybe I haven't been in Washington long enough, Mr. Chairman, but I can't figure out how something can be contrary to and consistent with the public interest at the same time. That kind of logic escapes us. Yet that is exactly the policy the CFTC has adopted on clearing.

Mr. Chairman, Will Rogers once wrote, everything is funny as long as it is happening to someone else. I guess the CFTC's inconsistent and incoherent exemptive policies might be funny except for the fact they aren't happening to somebody else; they are happening to us.

The CFTC is denying futures exchanges the fair competition Congress intended, while also denying market users the benefits exempt exchange trading would offer, price transparency, liquid trading, low regulatory costs, and financial integrity through clearing.

The CFTC, however, will have a chance soon to remedy this situation. The board of trade has decided to file an exemptive application for professional trading markets. As proposed, a professional trading market would be exempt generally from CFTC regulation subject to four basic conditions. One, only professional traders, not small, retail customers would be allowed; two, the board of trade operating the market must notify the CFTC before the operations begin; three, fraud and manipulation prohibitions apply as well as private damage actions; and four, all trades must be submitted to a CFTC-approved clearing system.

The professional trading market exemption would promote both responsible financial innovation and fair competition between exchanges and over-the-counter markets, the very purpose Congress cited when it gave the CFTC exemptive powers. Therefore, we will ask the CFTC to approve this proposed exemption immediately.

In conclusion, Mr. Chairman, the CFTC has thus far ignored the fair competitive mandate that you and others in Congress enacted. Our proposed professional trading market exemption affords the CFTC another chance to follow your mandate.

In any legislation you adopt dealing with the CFTC exemptive authority, we urge you to reaffirm the agency's duty to promote fair competition and to do so in terms that the Commission may no longer ignore.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Arbor appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Arbor, I appreciate that.

You mention that there were certain suggested changes that you would recommend pertaining to the language of the bill. Are those technical in nature that you are referring to or are they more substantive?

Mr. ARBOR. They are technical in nature.

Mr. ENGLISH. So from a substantive standpoint, you have no suggestions with regard to change in the legislation; is that correct?

Mr. ARBOR. No. Generally we agree with the bill.

Mr. ENGLISH. Now, the point that again I want to stress here is that the purpose of this legislation is not to reach beyond the jurisdiction the CFTC may have. That is, with regard to many of these instruments or decisions that will have to be made at a later time, but we do not want to send a signal that in any way a regulatory body of the U.S. Government is withdrawing from its dealings and responsibilities pertaining to fraud or antimanipulation.

I think that would be the wrong signal to send to any market that may be under the jurisdiction of a Federal regulator. So I appreciate your testimony and recognize that the points that you were making in referring back to the reauthorization bill were well taken. I am hopeful that we will see the CFTC pursue a course of evenhandedness and fairness to all who may come under their jurisdiction, and all of the various markets, whether they be on exchange or off exchange.

So I appreciate that very much.

Mr. Allard.

Mr. ALLARD. Thank you, Mr. Chairman.

I am curious, from your perspective, do you think the CFTC has the resources and the expertise to adequately police the antifraud jurisdiction?

Mr. ARBOR. If they have the resources and the authority to do it for the exchanges, we think they certainly would have it for the over-the-counter market.

Mr. ALLARD. Thank you.

That is all I have, Mr. Chairman.

Mr. ENGLISH. Mr. Holden.

Mr. HOLDEN. No questions.

Mr. ENGLISH. Ms. McKinney.

Ms. MCKINNEY. No questions.

Mr. ENGLISH. Mrs. Clayton.

Mrs. CLAYTON. No.

Mr. ENGLISH. Mr. Baesler.

Mr. BAESLER. No.

Mr. ENGLISH. Mr. Farr.

Mr. FARR. No.

Mr. ENGLISH. Mr. Sarpalius.

Mr. SARPALIUS. No questions.

Mr. ENGLISH. You get off light today, gentlemen. Thank you very much, we appreciate your testimony.

Our next witness is Mr. R. Wayne Klein, who is a securities bureau chief for the State of Idaho and he is representing the North

American Securities Administrators Association here in Washington.

Mr. Klein, we want to welcome you here today and would be happy to receive your testimony.

STATEMENT OF R. WAYNE KLEIN, CHIEF, SECURITIES BUREAU, STATE OF IDAHO, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Mr. KLEIN. Mr. Chairman, members of the subcommittee, good morning. My name is Wayne Klein. I am chief of the Idaho Securities Bureau and a member of the board of directors of the North American Securities Administrators Association, NASAA, on whose behalf I appear this morning.

In the United States, NASAA is the national voice of the 50 State securities agencies responsible for investor protection and efficient functioning of the capital markets at the grassroots level. NASAA and its members work closely with the Commodity Futures Trading Commission and the National Futures Association in combatting commodity-related fraud.

Mr. Chairman, members of the subcommittee, I appreciate the opportunity to appear here this morning in support of H.R. 2374, legislation now under consideration by the subcommittee which would amend the Commodity Exchange Act to ensure the continued application of the act's antifraud and antimanipulation protections, even in those instances where exemptions from regulatory oversight otherwise are granted.

We commend the subcommittee for addressing this critically important issue. We also would urge you to turn your attention to what we believe is a more general and disturbing trend at the CFTC: Abandonment and repudiation of its responsibility to protect the integrity of the commodity futures markets and those who invest there.

The intolerable situation we find ourselves in today is a direct result of the regulatory philosophy and actions of the Commission's leadership in recent years. It is not reflective of the work of the Commission's dedicated staff which deserves credit for its investor protection efforts.

The CFTC's recent order with respect to exempting certain energy contracts from regulatory oversight, including the antifraud and antimanipulation provisions of the Commodity Exchange Act is just the latest of what perhaps may be best characterized as the agency's reluctance to regulate, even in the face of blatant threats to investors and to the integrity of the markets.

Worse yet, the Commission has vigorously guarded what it believes to be its turf, only to turn around and severely limit its own role in what would appear to be a philosophy of, we won't police the area, but we don't want anyone else to either. It is the hope of NASAA and its members that such an approach will not persist and instead Congress and the Clinton administration will use their considerable authority to reenergize the agency with a clear sense of its original mission and purpose.

As a former enforcement attorney and a State securities commissioner, I have had personal experience observing the devastation that can occur in the lives of those who are particular victims of fraudulent commodity schemes. I myself have heard the outrageous lies contained in their telephone solicitations.

I have litigated with those companies offering programs that steal money from unsuspecting victims. In many cases the promoters were able to defraud the victims only because the victims—investors believed that these investment vehicles were subject to substantial Government oversight.

Based on my experience and as detailed more fully in my written statement, I feel that the CFTC is not performing the supervisory and law enforcement task contemplated in the legislative history of the Commodities Exchange Act. This inaction contributes to the fraud that is already occurring.

Mr. Chairman, members of the subcommittee, without active and vigorous oversight, the markets under CFTC exclusive jurisdiction will invite fraud and abusive trading. While the States are committed to detecting and prosecuting fraudulent operators in this arena, our role under the Commodity Exchange Act is very limited.

As a result, we respectfully would recommend that this subcommittee seriously consider the following six point action plan for reinvigorating the CFTC as an active and effective regulator of the commodity futures marketplace.

First, Congress should immediately move to pass H.R. 2374. This bill is absolutely necessary to mandate preservation of antifraud and antimanipulation authority even in those instances where regulatory exemptions otherwise are granted. The provisions of the bill should apply on a retroactive and prospective basis.

Second, the CFTC should be directed to withdraw its counterproductive 1990 Brent statutory interpretation. In doing so, the regulatory scheme governing the futures markets would revert to the guidelines and criteria articulated by the Congress and by earlier court decisions.

Third, Congress should consider requiring the CFTC to provide a reasonable scheduled review of this latest energy related exemption, then require each entity seeking use of the exemption to make a separate, publicly available application for exemption.

Each application should be accompanied by an explanation as to how the participant and the contemplated transactions satisfy the criteria set forth in the Futures Trading Practices Act.

Fourth, the CFTC should be directed to take great care in granting exemptions on a broad, generic basis without knowing who will be taking advantage of the exemptions. This may help reduce the potential for the exemptions to be used by crooks. It also would provide information to the CFTC about off-exchange trading with which to evaluate the effects of the exemption. Moreover, it makes publicly available such economic factors as the volume of, the price of, and parties engaged in, such trading.

Fifth, Congress should require the CFTC to embrace the policies set forth in the FTPA conference report accompanying the Commodity Futures Practice Act with respect to distinction between futures and forward contracts, the continued validity of prior case law establishing the futures contract definition and the jurisdiction of other regulators.

And sixth, Congress should consider prohibiting the CFTC from granting any exemption from its oversight for transactions which are similar in nature to those currently traded on the regulated exchanges. This may help reduce the migration of trading away from the exchanges, a trend which NASAA believes is contrary to the interests of the economy and the integrity of those vital markets.

Mr. Chairman, members of the subcommittee, the futures markets today are recognized at home and abroad as a vital part of the financial services industry. It is critically important that these markets remain as free as possible from fraud and manipulation.

As exclusive overseer of the futures markets, the CFTC alone has the authority to set the tone of regulation in this arena. If the CFTC fails to assert or exercise its jurisdiction, other regulators have only limited power to act and then may act only after violations have occurred.

NASAA and its members look forward to working with you and other Members of Congress to take the steps necessary to restore the CFTC to its original mission and purpose.

I thank you for this opportunity to express the views of NASAA. I am happy to answer any questions you may have.

[The prepared statement of Mr. Klein appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Klein. I appreciate your testimony.

We were told when the CFTC appeared before us earlier in the discussion with regard to this exemption that as far as any fraud is concerned, that States have fraud laws, and so therefore there is really not any problem, that the States could simply use their fraud laws to deal with any violations that might occur, any instances of fraud that might occur with regard to this market.

Could you give us your views with regard to that possibility?

Mr. KLEIN. Mr. Chairman, we appreciate the CFTC being so generous with providing work for us, but there are a number of reasons why we think that is a very inadequate solution.

One is that the CFTC is the one who truly has the expertise in this area and to say the States can use their general common law fraud statutes to apply is not going to give us the ability to go after the kind of frauds we ought to.

Also, the laws are not as specialized enabling us to go after particular suitability or misrepresentations without proof of an intent to deceive.

Second, only the CFTC has authority under the Commodity Exchange Act to enforce the Commodity Exchange Act on a nationwide basis. Yes, individual States can take action and can even shut down the fraud, but they will have to do it on a State-by-State basis, and we think it is inappropriate to require 30 or 50 States to take action in order to shut down a program operating nationally.

In addition, they are relying on us, the States, to bring enforcement action to remedy problems that could more easily be remedied by some restrictive requirements on the trading beforehand that prevents the fraud from occurring rather than saying, yes, when you find the fraud, please go after the people who commit it and put them in jail because the investors have still lost money.

Mr. ENGLISH. I am not an attorney, but it is my understanding that under the Commodity Exchange Act the States are preempted from the standpoint of any kind of State laws that might exist in dealing with violations under the Commodities Exchange Act. Is that correct?

Mr. KLEIN. Mr. Chairman, for the most part, that is entirely correct. Unlike the securities laws where the States have State's securities laws and the securities laws exist at the Federal level, under the Commodity Exchange Act, the CFTC is granted exclusive jurisdiction.

As a result of the prevalence of fraud, in 1928, there were some amendments to the Commodities Exchange Act granting the States some limited authority to take action but our ability to act is very limited against—we can only act after the fact. We cannot take any action to license people, to require substantive standards to be met beforehand, and there are a number of people that we are still precluded from taking action against.

Mr. ENGLISH. I guess the question that occurs to me, and again, not being an attorney, I certainly don't profess to have any legal expertise in this area, but given the fact that there is that exemptive situation as far as the Commodities Exchange Act is concerned, then the CFTC exempts a particular group of instruments from the antifraud and antimanipulation provisions under the Commodity Exchange Act.

Does that raise a legal question as to whether the States even after that exemption, since it may come under the jurisdiction of the Commodity Exchange Act, will they even have authority to act against fraud that they may discover within their boundaries because of the exemption and because of the application of the Commodity Exchange Act?

Mr. KLEIN. Absolutely, Mr. Chairman, because to the extent that the Commodity Exchange Act grants the States some limited authority to enforce the Commodity Exchange Act, to the extent the CFTC has granted an exemption and said that the Commodity Exchange Act does not apply, not only has the CFTC denied itself jurisdiction, they have precluded the States from using the Commodity Exchange Act to go after some of these operations.

Mr. ENGLISH. So that places us in a position where not only the CFTC has exempted itself from any kind of action against fraud or manipulation, they are also, in effect, exempting that kind of action by the States themselves.

Mr. KLEIN. It is so pernicious because in essence the CFTC becomes the protector of these operations, both the legitimate ones and the fraudulent ones.

Mr. ENGLISH. Mr. Allard.

Mr. ALLARD. The States, and I am interested in following up a little more on the chairman's checking out the State's role in this, the States, under the securities act, for example, on energy contracts, which is one of the controversies that have come up in here, do the States have any ability under their State security exchange acts to regulate at all, anything?

Mr. KLEIN. To the extent that the contracts could be construed as securities, yes, the States could use their securities laws.

Mr. ALLARD. Most of those contracts fall under those securities? Can they be construed that way?

Mr. KLEIN. Congressman, I have not seen the way the contracts are structured. In my opinion, they probably would not because securities laws require that you will be making an investment now, relying on someone else to make a profit, to return that profit to you in the future.

Under the futures contract, it is generally fewer parties and they are making the contract now and they are relying on each other.

Mr. ALLARD. Are you aware as to whether any of the energy States, those that produce oil and gas, have made any special effort in trying to regulate this area?

Mr. KLEIN. Congressman, they have made efforts. To the extent that we find fraud in this area, and Texas has been particularly active as has Oklahoma, to the extent they find fraud in this area, they do everything they can to stop it and if they can somehow stretch the securities laws to apply, they will.

Sometimes they will use the general and the common law fraud statutes. They are dedicated people who do everything they can to get money back for the victims and stop the frauds but the problem frankly is the laws do not address it well, particularly when the Federal law has granted exclusive jurisdiction over certain types of contracts.

Mr. ALLARD. Currently does the CFTC or any Federal agency have individuals in these States that are trying to enforce Federal law or work with the States in enforcing these laws?

Mr. KLEIN. Congressman, the CFTC does have several regional offices. However, to the extent that the CFTC has exempted these transactions or these parties, then the CFTC's regional offices will lack the authority to act, as well as having, I presume, instruction from the home office to ignore them.

Mr. ALLARD. I see. Are there any other Federal regulations that deal with this area that you are aware of?

Mr. KLEIN. Congressman, the only other one that I think would apply would be the general mail fraud statutes which would be administered by the postal inspectors as well as the FBI.

But I don't think that they are without work to do and it is difficult to use those statutes, although it was used successfully in, I believe, in some Chicago pit investigations.

Mr. ALLARD. Thank you, Mr. Chairman.

I yield back the balance of my time.

Mr. ENGLISH. Thank you very much.

Ms. McKinney.

Ms. MCKINNEY. Thank you, Mr. Chairman.

I just have one question and I don't know if it is for you or if it is for the chairman, but you make a recommendation in your testimony that the action that we take be retroactive.

Let me see if I can find it, and I want to know, I don't see that that is specifically stated in the legislation, is it?

Mr. ENGLISH. No, it is not. There is not a provision for it to be—excuse me—counsel is pointing out to me, they are required to go back and amend their orders, but as far as retroactive action against people who may be violating it, which I think you are referring to, any violations that have occurred since the order came out from the CFTC, they wouldn't.

But of course they are still in the process of implementing that order. So we are kind of in a twilight period here where both the CFTC is implementing the order that they have come down to at the same time that we may have it here.

Of course rules and regulations have to be promulgated to deal with this law should it pass and be signed by the President.

Ms. MCKINNEY. So to some extent it is retroactive. Is that what you are saying?

Mr. ENGLISH. Well, it is retroactive as far as the action that we are taking against what the CFTC has done in their ruling to exempt antifraud and antimanipulation. If you would be interested in offering an amendment along those lines, as has been recommended, that might be appropriate once we open the bill up for amendment.

Ms. MCKINNEY. Is that what you would recommend?

Mr. KLEIN. Mr. Chairman, Congresswoman, yes.

Because we have already had 2 months where the exemption has been in place and based on my experience, I can tell you that there are many fraudulent operations out there that are quickly going to the printers with new brochures and sales pitches and depending how much time elapses before this amendment can pass both Houses and be signed by the President. I think we need to close that gap.

Ms. MCKINNEY. OK, Mr. Chairman, I would like to do that.

Mr. ENGLISH. Thank you very much.

Mr. Smith.

Mr. SMITH. Mr. Chairman, thank you.

I am just coming up to my learning curve on this, but I would be curious whether your jurisdiction to protect against fraud matches your technical and staff ability to do that or is there somewhat of a false impression that we are sending out that you are really doing more than you are capable of doing?

Mr. KLEIN. That is always a risk that we—the Government sends out when they say: Here are the things that we will do and we have taken the responsibility to protect the markets against fraud.

And in a sense then, every time I bring an enforcement action, I am admitting a certain type of failure because I have only been able to act after the fact to put somebody in jail, to stop a fraud, to get money back for the victims.

We can never do the kind of job that we wish we could.

Having said that, however, I think that there is a tremendous amount of expertise and dedication at the State level in individual States and the States acting together, and with that expertise and those resources of combining efforts, the States have acted sometimes individually and sometimes jointly with the Commodities Futures Trading Commission to close down a number of large fraudulent operations, many of them nationwide.

And as a result, I think the expertise and the resources are there, never as much as we would like, but enough that we can go after the worst crooks.

Mr. SMITH. So, Mr. Chairman, as a follow-up, do I understand you to say that, no, you don't think we are misleading anybody in terms of your ability to protect against that fraud?

Mr. KLEIN. Congressman, I think that there is a real danger that we are misleading the public about what the CFTC is doing to keep the markets free of fraud. I think the implication, which you want the public to have, if they go trade on regulated markets, it is going to be safe and fair and free of fraud or manipulation.

I think that message is a false one, but I think that to the extent the States see fraud and can find any way to act, they will.

Mr. SMITH. Thank you, Mr. Chairman. That is all I have.

Mr. ENGLISH. Mrs. Clayton.

Mrs. CLAYTON. Mr. Klein, the tone of your testimony is interesting as well as your written work. I am interested to know a little bit about the relationship between the States and the CFTC.

Has it deteriorated or was there ever an area when you felt they weren't really performing their regulatory jurisdiction? Was there a time when they understood what their oversight responsibility was and had a good relationship protecting the public, or has something occurred within the recent period of time that we need to address?

Mr. KLEIN. Congresswoman, I would like to first make a distinction between the policymakers on the Commission and the staff. In the midlevel, staff members, the Directors of the various divisions and their staff people have always gotten along very well with the States.

But as far as the CFTC as an entity, it has been a roller coaster. Prior to 1982 the CFTC was very intent on protecting its exclusive jurisdiction, to the point that even in late 1979 or 1980, States had brought some action against fraudulent operations and the CFTC actually intervened in those lawsuits saying the States had no authority, and that led to Congress adopting the amendment in 1982 giving the States some limited authority, and things went very well until about 1985 when the CFTC adopted an exemption or essentially gave a no action position—opinion letter—for bank financed precious metals which spawned a whole new generation of fraudulent operations where people would buy the metals. They put 20 percent down. The metal would then be transferred to some other entity which would hold it, and the CFTC said that takes it out of the futures contract, and that then spawned many frauds.

And then from there the branch statutory interpretation, the CFTC's action in connection with a lawsuit in A-Mark that is mentioned in my testimony and now this exemption has strained relations very much with the policymakers of the Commission although it remains fairly good with the senior staff.

Mrs. CLAYTON. Is there, in your judgment, philosophically, a trend that we need to be conscious of that needs to be stopped? Apparently this policy, if they have exclusive jurisdiction, is that their interpretation or is that actual policy?

Mr. KLEIN. Exclusive jurisdiction provided visions are contained in the Commodity Exchange Act and the statute grants them that jurisdiction. Yes, I think there is a trend and I think it is a dangerous trend.

I think it perhaps can still be reversed, but they are not listening to the staff and unless things change soon, it is going to be too late to go back.

Mrs. CLAYTON. Do you have recommendations about that beyond your testimony?

Mr. KLEIN. Congresswoman, the recommendations we would have are contained in my testimony and the attachments which are included and letters that have been submitted to the CFTC and to the President.

Mrs. CLAYTON. Thank you very much.

Thank you, Mr. Chairman.

Mr. ENGLISH. Mr. Gunderson.

Mr. GUNDERSON. Thank you very much, Mr. Chairman.

Mr. Klein, I want to read to you a statement from Commissioner Dial as a part of his testimony submitted to this subcommittee.

"As of this date, no one has put forth a plausible scenario whereby the exempted energy contracts would subject the public interest to a fraudulent scheme. Granted, there are those who ascribe to the theory that this exemption will allow for general public participation through the use of pools, trusts, or partnerships and the CFTC would not be able to use the 4(b) fraud provisions to prosecute fraudulent activity in these circumstances. That is not the case."

Will you comment on that statement?

Mr. KLEIN. Congressman, I deeply wish he were correct—wish I could agree with him. Unfortunately, I think that his own division of enforcement disagrees based on the memo that I have seen that they submitted to the chairman before this exemption was granted.

In addition, some discussions I have had with people familiar with the CFTC, we have identified situations where it is possible that people are going to pool their money, it will be invested by someone else claiming to meet the minimum asset requirements contained in this exemption and, yet, they are not truly going to be the sophisticated investors that they appear to be.

And the ones who are going to lose money are going to be the investors who participate in this pool and it is going to be an unregistered commodity pool, or it will be a company whose stockholders are just investing, or it is going to be people who are going to find some other way around it, and as we saw in A-Mark unfortunately, the lawsuit that we brought as bankruptcy trustee, some courts at least are willing to say that a small dealer who works out of an old house and buys and sells used gold fillings and school rings qualifies as a commercial entity, and I think it is a mistake to say that those people are able to protect themselves against multibillion dollar companies.

Mr. GUNDERSON. So you do not believe that the antifraud provisions under 4(b) are adequate to prosecute?

Mr. KLEIN. Congressman, I do not.

Mr. GUNDERSON. OK.

Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you.

Ms. Long.

Ms. LONG. I have no questions.

Mr. ENGLISH. Well, thank you very much. I appreciate it, Mr. Klein, your testimony has been most helpful.

Mr. KLEIN. Thank you, Mr. Chairman.

Mr. ENGLISH. Our last witness this morning is Mr. Kenneth Raisler, who is with the Energy Group from New York.

STATEMENT OF KENNETH M. RAISLER, ATTORNEY, ON BEHALF OF THE ENERGY GROUP

Mr. RAISLER. Thank you. Mr. Chairman, and members of the subcommittee, my name is Kenneth Raisler. I am an attorney with the law firm of Sullivan & Cromwell. I am appearing today on behalf of nine energy companies, each involved in commercial business relating to crude oil, natural gas or their products and byproducts.

I represented these energy companies in their application to the CFTC for an exemption that was the subject of this committee's earlier hearing and has been discussed today. I have submitted a written statement for the record which sets forth in detail our position on H.R. 2374.

In my oral statement, I wish to make only a few brief points.

First, as a personal matter, prior to joining Sullivan & Cromwell, I served in the U.S. Department of Justice, including a tour as a criminal prosecutor in the District of Columbia. I also served as the General Counsel of the Commodity Futures Trading Commission. In that capacity, one of my jobs was Chairman of the CFTC State advisory committee and I am pleased to say from Mr. Klein's testimony it was during the period of 1982 to 1985 when the roller coaster, at least he indicates, was at high level.

From my personal perspective and the perspective of the group I represent, I am adamantly opposed to fraud in any market, including the market covered by the energy exemption. My view and the view of the group that I represent is that the bill is not an effective way to address this issue.

Instead, it may create false impressions and confusion that may deter important participation in these markets.

Congress in the 1992 Futures Trading Practices Act directed the CFTC to address an exemption for forward contracts in order to resolve what was legal uncertainty that came about as a result of one district court decision in New York.

Forward transactions, it is very important to realize, are and always have been excluded from all of the provisions of the Commodity Exchange Act and CFTC jurisdiction, not just antifraud, but they are outside the act in their entirety.

Transactions described in the exemptive order are generally recognized to be such forward contracts outside the CFTC's jurisdiction. The exemptive order seeks to clarify this very point.

In our view, application of the CFTC's antifraud jurisdiction only confuses the picture. The CFTC has never overseen or been involved in policing these markets. I believe that is just a critically important point. Without the staff or the expertise, retaining antifraud jurisdiction could create a misleading impression about the CFTC's abilities.

Moreover, CFTC authority is limited. The CFTC has to prove that these contracts are, in fact, futures contracts and in fact they are generally recognized instead to be forwards. Parenthetically, I would point out that that debate opens up court actions on what is a futures contract versus what is something that is not a futures contract, which is the very point that this committee and the Congress sought to avoid by giving the CFTC exemptive authority.

We are unaware of any evidence of fraud in these markets or any of the markets covered by the exemptive order.

In fact, Mr. Klein made reference to fraudulent operators out there and going to the printer. We are unaware and we would be most interested in hearing about any such evidence. We are aware of none and to our knowledge we are not aware of any that have occurred in the past either.

If problems arise in these markets, it is our view that both the participants and the authorities can seek recourse under applicable State and common law. In fact, the CFTC and every authority that I am aware of is on record that the goal, when there was fraud involved, is to bring criminal prosecutions.

Criminal authority is free and available to the Federal Government using mail and wire fraud statutes and they have repeatedly used those in any kind of activity that involves fraud, as well as the States using their various statutes to bring to bear.

It is important to recognize that the exemptive order does not permit activities that could be the cause of public fraud. The general public and individuals are not eligible for the exemption. Both parties to the energy exemption contracts must be commercial participants with substantial net worth or assets, at the $1 million level for net worth and $5 million for assets.

Public marketing and sales, whether high pressure or not, are not permitted. Thus, if such activity, and I believe the activity that Mr. Klein described, were to occur, it is our strong belief that the exemptive order would not apply in any way and the CFTC would have available its full panoply of authority, not just its antifraud authority.

The goal of legal certainty sought by the energy companies has been achieved by the CFTC's exemptive order. Foreign counterparts, no longer confused about the applicability of the act and CFTC jurisdiction, are prepared to enter into energy contracts in the United States.

This result provides important benefits to the U.S. energy companies and energy consumers allowing greater certainty in the pricing and sourcing of energy.

We endorse the goals of Congress in enacting the Futures Trading Practices Act which provides the CFTC with important discretion. If an exemptive order like that issued for energy contracts is determined to have unintended effects, the CFTC can always revisit it and tighten up its requirements or clarify its terms.

In our view, in fact, that is the better approach because the CFTC antifraud authority on its own is insufficient. It would need, if it finds activities to go outside, to go beyond antifraud and look to other regulatory and other kinds of prohibitions and the way to do that, in our opinion, is to modify the exemptive order if problems occur.

We see no reason for problems to occur because the exemptive order is very carefully designed to avoid the public marketplace.

For these reasons, we do not endorse the automatic application of the act's antifraud provisions. I appreciate the opportunity to appear before the committee and would be happy to answer any questions that the committee has.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Raisler appears at the conclusion of the hearing.]

Mr. ENGLISH. Thank you very much, Mr. Raisler, I appreciate that.

As was pointed out by Mr. Klein, I was particularly struck by the fact that this particular action, this exemption from fraud and manipulation, any type of fraud and manipulation application of the Commodities Exchange Act, that that recommendation came from the economic division over CFTC, while being opposed, strongly opposed, by the enforcement division.

Now, it may be fine from an ivory tower economic theory standpoint to say, hey, we are opposed to all regulation. Let's deregulate, and if that is where we are, then we might as well do away with all our Government entities that have regulations as their responsibility.

That is free trade, that is wide open, and I understand that many in our country would like that, many who are ivory tower-types. Then we have the other types. We have the fast buck boys and the fast buck boys are always looking for an edge and if you are going to open the door and say, the Federal Government is not interested in whether you create fraud, involved in fraud or manipulation of markets, I guarantee you they are going to be delighted to step in and take advantage of that situation.

Now, I don't think that the people at the CFTC who voted for this two to one, that was what the margin was of the Commissioners, we have a lot of vacancies over there, don't we?

Mr. RAISLER. That is correct.

Mr. ENGLISH. Two to one. I don't believe those two who voted for this actually want to open this market up for fraud and manipulation. I believe that they listened to the ivory tower-types, but I think it would be very naive, as I told them before, to expect that is going to be the case.

I would also make the point that where you are talking about being misunderstood, foreign counterparts might misunderstand, I have never been able to understand why people overseas would feel that it is somehow confusing that we are opposed to fraud and manipulation.

Most people, it seems to me, when they enter into a transaction, like to feel like they are going to be dealt with fairly, not some fast buck guy in there that is going to gouge him. And I can assure you, whether they are domestic or foreign, if we are going to turn our back as a Nation, those people are going to be present. They are in our society.

It would be nice if it were not the case, but I have a very hard time buying your argument that somehow these people are going to feel that in some way it is burdensome to be protected from fraud and from manipulation. That is an interesting argument, but I simply don't think that exists.

Now, I have also heard from some, well, these are the big boys. We shouldn't concern ourselves because these are the big boys. Well, the big boys fall too, and when they fall, they fall on a lot of little people. The little people get hurt when the big boys fall, and the big boys are just as subject to manipulation and fraud as anybody else, and perhaps we shouldn't concern ourselves whenever they get gouged or taken, but we have a lot of companies that these big boys represent, and when those big boys go down, when they go into bankruptcy, whenever they have problems, that reverberates throughout the economy and a lot of little people get hurt.

I think all the people of this country deserve to be protected from fraud. They deserve to be protected from those who would manipulate, and quite frankly, I am astounded by the fact that you would come here before us saying that, golly, we shouldn't extend our laws dealing with fraud and manipulation to those who may come under the jurisdiction of the CFTC, and as I am sure you are well aware, this legislation of course applies only in those cases, to those instruments, that are not covered under the jurisdiction of some other regulator.

So I don't have any questions, but I have to say, I felt compelled to make those points.

Mr. Allard.

Mr. ALLARD. From your perspective, do you feel that the antifraud and the rules and regulations that we have in place now prevent boilerroom operations, particularly in regard to the energy contracts that had come up as an issue with the CFTC?

Mr. RAISLER. I think there is very much a misimpression about this CFTC exemption and who it applies to. In our strong view, any boilerroom-type activity would not be eligible for this exemption. So the issue of the application of antifraud is irrelevant. The legislation, therefore, is irrelevant.

Our view is if somebody, in the chairman's words, the fast buck boys are out there selling this product to somebody, the CFTC exemption does not apply, and I don't want to send a signal to anybody out there that they should be able to take advantage of this exemption under those means.

The fact is that it is very important, and I agree with the chairman's comments, that everyone in this country and throughout the world deserves to be protected from fraud. The fact of the matter is that the CFTC's application of antifraud jurisdiction under this bill is a very narrow aspect and that the people who are out there marketing boilerrooms should understand that they have no opportunity to get the benefits of the CFTC exemption, and if they try to rely on the exemption, it should be clear from the CFTC, and everybody else, that their business should be put to a halt, and that that exemption does not apply and all CFTC jurisdiction can be brought to bear to shut them down, and hopefully the States and the Federal criminal authorities are also at hand.

Mr. ALLARD. In the early part of your testimony, you had begun to draw some distinctions between forwards and how these energy transactions may differ.

Is there a significant difference between forwards and the energy contracts who have the exemption?

Mr. RAISLER. No. In our view, not at all.

The fact of the matter is that this whole issue comes up because a district court in New York found that some of these contracts were, in fact, futures.

Our position is that decision was wrong. The CFTC issued a statutory interpretation in effect saying that that decision was wrong. The exemptive authority gives us a way to put a belt with those suspenders, if you will, to make it clear to everybody out there that this activity is forwards activity. In effect, this activity is outside of CFTC jurisdiction.

That is the goal that we went to Congress and sought in the legislative history to the Futures Trading Practices Act and that is the goal we believe was achieved by the exemptive order. So I think that is important to recognize, we are not talking about deregulation in this market.

That it is a forwards market; that the CFTC, since the Commodity Exchange Act was adopted in 1922, has never had jurisdiction over the buying and selling of goods which, in effect, is what this energy exemption seeks to clarify and affirm.

Mr. ALLARD. In your view then, does the CFTC have the resources and the expertise to regulate the energy exemptions if we bring them back in under the fraud?

Mr. RAISLER. Our opinion is no. The fact is the CFTC has never regulated or overseen or policed the forward markets. The CFTC's resources are limited, as this committee well knows.

The CFTC does not have any individuals stationed in any of the States that are energy producing or energy trading States. There are no CFTC employees in Texas, Oklahoma, or Louisiana, for example. To expect the CFTC, and this is where we are concerned about a misleading impression to the marketplace, to expect the CFTC to be policing fraud wherever it occurs in the country I believe gives the public a misleading impression about that level of protection. If it is determined that protection is needed, a more radical step than giving CFTC antifraud jurisdiction should be the way to solve the problem.

We don't believe that is necessary because the exemption is narrowly drawn to a marketplace that has never been regulated by any Federal regulator, including the CFTC.

Mr. ALLARD. What has been your experience in dealing with the States? We had a previous witness who gave the State's perspective on the rules and regulations.

And now representing those who are regulated or could be regulated, what is your perspective on the State's role in this area as far as regulation is concerned?

Mr. RAISLER. I think it is important to recognize that the States do have an important role to play. The CFTC, in fact, if I can go back a bit in time, in 1982, which is when Mr. Klein talks about the environment changing at the CFTC and there was a better relationship with the States.

In 1982 this committee recommended and Congress adopted a change to the Commodity Exchange Act. Up until that time the CFTC was exercising exclusive jurisdiction over not just the markets in which—the futures markets, the exchange traded futures markets, but also the cash markets and where commodity advice is being given.

The CFTC recommended, and this committee endorsed, taking away that authority from the CFTC and giving the States very broad authority to develop their own laws. In fact, the States have moved forward with a model State commodity code to prohibit the boilerroom and bucketshop activity at the State level.

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This has been a very important initiative adopted by a number of States and strongly supported by the CFTC and I believe the public at large. The States have an important responsibility. They have worked closely with the CFTC over a number of years. It is important to recognize as these markets evolve that the States continue to have a responsibility and that responsibility particularly is focused on the fraud level, particularly focused on the boilerroom level at the local—in the local areas.

Mr. ALLARD. Madam Chairman, I tried to clear up in my mind sort of a chronology here——

Ms. LONG [assumed chair]. Without objection.

Mr. ALLARD. So we had a period of time there where there probably wasn't much thought or concern about commodities or the futures and swaps and those sort of gray contracts, that gray area, and then was there a period of time when we had the CFTC explicitly prohibit the States, where they actually exempted the States and then went back into a period of time after that where then the States then were allowed this regulatory authority and they are in the process now of passing the CFTC acts that you referred to in your comments?

Mr. RAISLER. Right. If I can—prior to 1982, the CFTC effectively preempted the States from dealing with off exchange trading, that is, the trading that existed away from the futures markets. That changed in 1982.

The States now have very broad authority and they have authority to adopt, at the State level, their own laws. There is the model State commodity code which each State is free to adopt and a significant number of States have adopted a form of model code.

The intent of that model code is to prohibit commodity-related fraud at the State level and the CFTC has worked with the States to do that since 1982. In the last decade, enormous progress has been made and a lot more vigilance has been paid to the boilerroom activity.

Let me just point out that from our point of view, the whole discussion of fraud in the boilerroom context really does not apply to this energy exemption which we believe would not be available to a boilerroom-type purveyor, but my answer to your question stands with that caveat at the end.

Mr. ALLARD. Thank you, Mr. Chairman.

I see my time has run out.

Mr. ENGLISH [resuming chair]. Ms. McKinney.

Ms. MCKINNEY. No questions, Mr. Chairman.

Mr. ENGLISH. Mr. Penny.

Mr. PENNY. No.

Mr. ENGLISH. Ms. Long.

Ms. LONG. You have partially answered this, but I would simply say that if you think there is no fraud or abuse, then if you would just say specifically why you oppose the bill.

Mr. RAISLER. I think there are several reasons. The first is that by enacting this bill and giving the CFTC this antifraud authority, you are creating, I believe, the impression in the marketplace, one, that a variety of activities that we believe are not covered by the exemption may be permitted under the exemption and the CFTC should therefore use its antifraud authority to stop them.

Two, you are creating the impression that the CFTC will be able to stop fraud in these markets if such fraud were to occur when, in fact, the activity is basically outside the exemptive order. Both the States and the CFTC are able to proceed to stop that fraud now with the exemptive order in place and there is no reason to impose that.

The last point is that bringing antifraud into the exemptive order creates confusion as to what is the CFTC's jurisdiction in this area. We have sought by the legislation in 1992 and the exemptive order, to clarify in essence that these are forward contract-like instruments which the CFTC has never had any jurisdiction over.

We believe that is the right result and that is the result that is indicated by a pattern of activity, including an earlier statutory interpretation of the CFTC. Bringing antifraud in basically says, in effect, these things are futures-like and forces the CFTC, if it wants to proceed with a fraud case, to prove that contracts which we have tried to present to be forwards and not under CFTC's jurisdiction are finding their way into the CFTC's jurisdiction again as futures, and that debate is one we thought we had avoided with the exemptive authority and with the 1992 legislation.

Ms. LONG. Thank you.

I don't have any other questions, Mr. Chairman.

Mr. ENGLISH. Thank you very much.

Mr. SMITH.

Mr. SMITH. Help me understand what kinds of fraud might be an example of—that would take place that the lesser ability of the CFTC couldn't determine.

Help me understand what kind of fraud might happen.

Mr. RAISLER. I think that if I understand your question and if I don't, please redirect this to me.

Mr. SMITH. I don't have an understanding what kind of fraud might happen in this energy contract.

Mr. RAISLER. There are really two kinds of frauds that people are talking about today as I hear it. One is the sort of purveying to the general public—this sort of boilerroom-type activity that has gone on in precious metals historically where people are getting on the phone and hawking a product. People are sending out literature saying, gold is going through the roof or whatever, and that kind of activity is not covered by this energy exemption at all.

So in our view, the CFTC has full authority to stop that kind of boilerroom activity, as do the States under their various State statutes.

The other kind of fraud——

Mr. SMITH. Excuse me. Would there be more penalties, if you didn't have the exemption and it was discovered, would there be more penalties than just the prosecution under State statutes?

Mr. RAISLER. No. I would say it is apples and oranges. The exemption has nothing to do with that boilerroom business. That boilerroom business cannot rely on the energy exemption so therefore that boilerroom business is thrown back into all of the provisions that make their conduct illegal.

So there is no—the current energy exemption really has nothing to do with the boilerroom business.

Mr. SMITH. But it has to do with some business. It might not otherwise be covered under the State statutes.

Mr. RAISLER. The kind of fraud one thinks about—the energy exemption applies to when two over-the-counter parties, both commercial entities who are in the energy business, deal with each other, and it is certainly possible that in those dealings one could defraud the other—one could make—I mean, it is—one could not pay on its contract, one could misrepresent its assets, one could misrepresent that they had the oil when they hadn't yet bought it.

Those are the kinds of disputes between two commercial parties that historically have, if they have existed and generally in this market we are not aware of them, but if they had existed, would be the subject of litigation between those two commercial counterparties where they could rely on a whole variety of common law and State fraud statutes as well as contract statutes and other legal remedies.

Mr. SMITH. Mr. Chairman, I don't want to take any more of the subcommittee's time.

I will pursue this, my questions directly, but my experience is that the less our ability to determine that fraud and criminal activity, sometimes the greater the penalty helps to act as a deterrent.

Mr. ENGLISH. Will the gentleman yield?

Mr. SMITH. Yes, sir.

Mr. ENGLISH. One statement you made I am having a great deal of trouble understanding, Mr. Raisler, how in the world, with regard to any kind of action taken, if CFTC has exempted itself, that is what is happening. They are totally exempt. They can't take action under any circumstances?

Mr. RAISLER. Just one quick point on that, Mr. Chairman, just to clarify. The CFTC has——

Mr. ENGLISH. Isn't that correct?

Mr. RAISLER. Just one specific point. The CFTC is——

Mr. ENGLISH. All I am asking is it true or not?

Mr. RAISLER. With one exemption. The CFTC has retained antimanipulation authority.

Mr. ENGLISH. That was another question I was going to ask you. Since they have retained that antimanipulation authority, and I believe you said in response that they don't have the capability to deal with any kind of antimanipulation or any manipulation that may take place, but they have the authority on price manipulation, don't they?

How can you, in fact, have the capability to carry out the responsibilities on price manipulation, in fact, how can you have any jurisdiction if you have the capability of taking action on price manipulation, but you don't have it in any other area of manipulation?

Mr. RAISLER. I believe the CFTC has full authority in the manipulation area.

My comment was directed to the fraud area. Manipulation is when you manipulate the price in the marketplace and the CFTC, through the futures markets in particular, has always been concerned about that.

Mr. ENGLISH. You said that they don't have jurisdiction. This is a forward contract. CFTC has no jurisdiction, therefore, CFTC can't get involved, can they? You either got it or you don't have it.

Mr. RAISLER. CFTC always has jurisdiction over price manipulation.

Mr. ENGLISH. No matter whether it is a futures contract or not?

Mr. RAISLER. That is correct.

Mr. ENGLISH. That is not a futures contract, if it is something CFTC has no jurisdiction over, they in no way can take any kind of regulatory action against a security. That comes under the SEC.

You can't take it against any other kind of instrument. The only jurisdiction they have is on a futures contract and the problem came about in this area because you had a court determine that these were futures contracts.

Mr. RAISLER. Mr. Chairman, on the issue specifically of manipulation, the CFTC has always had authority over the cash markets. Specifically in connection with the attempted manipulation of the silver market in 1980 by the Hunt family, the CFTC did proceed——

Mr. ENGLISH. Those were on market, on exchange transactions.

Mr. RAISLER. The CFTC's proceeding was a manipulation of both the futures market and the cash market and its enforcement authority affected both the futures market and the cash market.

Mr. ENGLISH. The only authority they have is if that is determined to be a futures contract and the way that the CFTC is determining if it is a futures contract today is if it is traded on an exchange.

If it is not traded on an exchange, I don't believe you can name me a single instrument that is being traded off exchange that the CFTC has been making the determination they have any kind of authority over it, doesn't matter what the court says.

Mr. RAISLER. CFTC continues to bring proceedings on off exchange futures trading, including in the foreign exchange market.

Mr. ENGLISH. Name one.

Mr. RAISLER. There are two cases pending in the eastern district of New York involving foreign exchange trading.

Mr. ENGLISH. None of those contracts are being traded on exchanges at all?

Mr. RAISLER. That is correct.

Mr. ENGLISH. Any exchange in this country, absolutely none?

Mr. RAISLER. If I understand the chairman's point, the people who sold those contracts were not trading them on an exchange.

Mr. ENGLISH. That isn't the point. The question is, are those instruments being traded on an exchange?

Mr. RAISLER. If I understand the chairman's question——

Mr. ENGLISH. You understood my question. Is it being traded on an exchange or is it not?

Mr. RAISLER. It is not.

Mr. ENGLISH. Absolutely. Nowhere in this country on any exchange that is regulated by the CFTC are any of those instruments being traded in any form?

Mr. RAISLER. The answer to that question is certainly yes.

Mr. ENGLISH. All right. That is my point. That is where the tie comes in.

If these contracts are not being traded on exchanges, the CFTC, from a practical standpoint, has made the determination those are not futures contracts and they have no jurisdiction. If they are futures contracts, they are required to be traded on exchanges, aren't they?

Mr. RAISLER. Not pursuant to various exemptions the CFTC has granted and not pursuant to the——

Mr. ENGLISH. I will come back. CFTC has made under the law, under the Commodity Exchange Act, if an instrument is determined to be a futures contract, the CFTC says it has to be traded on exchanges. In fact, the law says it has to be traded on exchanges; isn't that correct?

Mr. RAISLER. I agree that is what the law says, yes.

Mr. ENGLISH. All right. I know that you may not like the law, but that is what the law says.

Mr. RAISLER. But the CFTC is granted a variety of exemptions, including the recent swaps.

Mr. ENGLISH. That is exactly why we are here today. They have granted a variety of exemptions and that is exactly the problem. The CFTC is whiddling away at the law.

In this case we have gone to the point where in fact they are willing to exempt fraud and manipulation. The question that is going to come down to and going to be determined by this Congress and by this legislation is whether or not this Congress is going to endorse that or not.

We have carried the issue of deregulation to the point that a regulatory agency says we are going to turn a blind eye to fraud and manipulation, even if it is in our jurisdiction, even, in fact, in light of the fact that this Congress, through its reauthorization, stated, we are going to determine whether off exchanged instruments are being traded, what they are and who they will be regulated by.

We want status quo. Whenever you start exempting on the basis of fraud and manipulation, that is not status quo, and that is what brings us here today.

Mr. Nussle.

Mr. NUSSLE. Thank you, Mr. Chairman, and just to make sure I understand the remedy that you are prescribing in the alternative of passing this particular piece of legislation is the civil courts?

Mr. RAISLER. Two basic remedies is that the parties of course have—and the authorities have the criminal courts as well as the civil courts available, but to the extent that this exemption is found to raise the possibility of abuse in some area, the CFTC, because it is only an exemption, the CFTC can revisit it.

And our position is that as the major players in these markets, we don't want fraud in these markets. We have no interest in promoting fraud in these markets and if there is a problem and we don't believe the way this is designed there will be, but if there is a problem, we will be the first to recommend the CFTC revise the exemption to clarify that certain participants should not be eligible for it, and that is in addition a very significant remedy that is available to the CFTC and to the public at large.

Mr. NUSSLE. But having this in effect, doesn't that provide some deterrent effect? You are talking about closing the barn door after the horses are out.

I am saying, is there a deterrent effect of having this kind of legislation on the books?

Mr. RAISLER. The concern that we have is that there may be more confusion than deterrent by putting this on the books.

Mr. NUSSLE. Sometimes confusion is a deterrent.

Mr. RAISLER. Well, the question though is whether that may deter legitimate players from participating in the market because they are concerned about the scope of the CFTC's jurisdiction in an area which is basically deemed to be forwards outside of CFTC jurisdiction.

That is the concern in terms of confusion.

Mr. NUSSLE. OK, but the bottom line though is that the real remedy that you are prescribing in the alternative of this legislation is the civil courts.

You are basically saying let the buyers beware, let the market beware, and you are on your own, you take care of it on your own. You have to investigate it, you have to uncover it, you have to be aware of it, and then you have to prosecute it.

Mr. RAISLER. And let me point out, as a general matter in this country the buying and selling of goods, whether they be energy or any other kind of product, find themselves with that remedy, yes.

Mr. NUSSLE. Usually on a lot less sophisticated scale. Buying a candy bar at a local convenience store is not the same as purchasing securities, forwards, futures, or whatever it might be.

Mr. RAISLER. We are not talking here about investment contracts. What we are talking here about is the buying and selling of cargoes of crude oil and pipeline delivery of natural gas, between the kind of people that are represented in the Energy Group.

These are commercial contracts to move physical product across State lines for purposes of getting that oil to the powerplant or to the corporation that needs it.

These are not candy bar purchases, these are not retail purchases, and these are not investment purchases. These are people who are trying to buy and sell crude oil, natural gas, and their products for their businesses.

Mr. NUSSLE. And the Government has no place regulating or monitoring that particular transaction, in your opinion?

Mr. RAISLER. The Government never has, and so we see no reason for them to start now.

Mr. NUSSLE. Well, if the Government never has, why would they have granted an exemption?

Mr. RAISLER. The district court in the southern district of New York reached a conclusion which the CFTC disagreed with but was nonetheless on the books, creating confusion about whether some of those contracts might be futures under the CFTC's jurisdiction.

Our goal here was to clean that up. The CFTC statutory interpretation did that in part. This exemption was intending to make the rest of that clear, and that is the full extent of what we were trying to achieve here, no more.

Mr. NUSSLE. Thank you, Mr. Chairman.

Mr. ENGLISH. Thank you very much, Mr. Nussle.

I would like to say, Mr. Raisler, before you leave, I think the impression is that since you are representing the Energy Group, that this is a few big oil companies that are involved in all this trading around back and forth, and those are the guys that are involved.

It is also my understanding the people who are involved in these kinds of contracts, the people who would be subject to any fraud or manipulation that may take place, also include municipalities that operate power facilities, rural electric cooperatives and other power suppliers, fleet operators, barge companies, railroads, airlines.

Wouldn't take but just a little manipulation, a little fraud to push some of these airlines in bankruptcy and goodness knows what impact that would have on our economy, other transport companies, fertilizer producers, blasting producers, aluminum, steel producers, and other energy dependent manufacturers, farmer supply cooperatives, and home heating associations, just to name a few.

Mr. RAISLER. That is certainly correct, Mr. Chairman.

Mr. ENGLISH. And I don't hear any of them coming up here and saying, golly, gee, throw me in that briar patch with all that fraud and manipulation. We sure want to be manipulated.

We sure want a little fraud, so be sure and don't pass any bill that is going to prevent us from being involved in all this fraud and manipulation here.

Mr. RAISLER. Mr. Chairman, the CFTC did put this exemptive order out for public comment. It got 16 comments back and nobody—and the CFTC specifically raised the antifraud issue. Nobody argued then.

The State securities people did not come in, weigh in on the issue, nobody put forward on that record a request that the CFTC apply antifraud and in fact the vast bulk of the comments are specifically recommended against it.

So there has been an opportunity for people to weigh in on this specific point and the CFTC teed it up and nobody was prepared to hit it.

Mr. ENGLISH. Would you please name the members of the Energy Group so that we all know specifically who it is that is up here testifying in favor of fraud and abuse, manipulation?

Mr. RAISLER. Mr. Chairman, I would be happy to name the members of the Energy Group. We should be making it clear that we are not testifying in any way in favor of fraud or any other——

Mr. ENGLISH. I am happy to hear that. So you have no problem with the objective of the legislation?

Mr. RAISLER. We have no problem with deterring fraud in any market.

Mr. ENGLISH. I am happy to hear that.

Mr. RAISLER. If you wish, our written testimony includes the names of the companies and I will read them. This is only in alphabetical order, so I am not——

Mr. ENGLISH. You are not slighting anyone.

Mr. RAISLER. That is correct. BP Oil Company, Coastal Corporation, Conoco Inc., Enron Gas Services Corporation, J. Aron & Company, Koch Industries Inc., Mobil Sales and Supply Corporation, Phibro Energy Division of Solomon, Inc., Phillips Petroleum Company.

Those are the nine companies who comprise the Energy Group who submitted the application to the CFTC for the energy exemption and on whose behalf I am testifying today.

Mr. ENGLISH. I appreciate that very much.

Thank you very much, Mr. Raisler.

Mr. RAISLER. Thank you, Mr. Chairman.

Thank you.

Mr. ENGLISH. That concludes our witnesses today.

[Whereupon, at 11:45 a.m., the subcommittee proceeded to other business.]

[Material submitted for inclusion in the record follows:]

WRITTEN SUBMISSION OF PATRICK H. ARBOR,

CHAIRMAN,

BOARD OF TRADE OF THE CITY OF CHICAGO

ON H.R. 2374

Mr. Chairman and members of the Subcommittee, I am Patrick H. Arbor, Chairman of the Chicago Board of Trade. Thank you for your invitation to present the views of the Board of Trade on H.R. 2374 and the actions taken by the Commodity Futures Trading Commission under its new statutory exemptive authority.

Support for H.R. 2374

The Chicago Board of Trade generally supports H.R. 2374. That legislation would confirm that any person or transaction the CFTC exempts under Section 4(c) of the Commodity Exchange Act must remain subject to fraud and manipulation prohibitions.

The Board of Trade and other exchanges addressed this issue in their December 1992 comment letter on the CFTC's proposed swaps exemption. The exchanges urged the CFTC to exempt only those transactions that would be subject to "core protections" under the CEA, including antifraud and antimanipulation. The exchanges specifically stated:

> "No one can legitimately claim that swaps that are futures should be excused from the CEA's antifraud and antimanipulation provisions. Those protections are central to the customer protection and market integrity purposes underlying the CEA."

The Board of Trade also incorporated those comments in its comment letter on the CFTC's energy contract exemption.

Unfortunately, in differing degrees, both the CFTC's swaps and energy contract exemptions deviate from that policy. Under the swaps exemption, anyone manipulating the price of an exempt swap would not violate the CEA unless that manipulation effected a ripple manipulation on a futures exchange or in the cash market as a whole. The swaps exemption also may be illusory or at least cumbersome when it comes to fraud. Any fraud action would require the complaining party to prove first that the swap is a futures contract and second that fraud occurred. Other than shielding wrongdoing, no reason exists to make the complaining party make a double showing.

The energy contract exemption has the same flaw in the manipulation area as the swaps exemption and contains no antifraud protections. H.R. 2374 would remedy the fraud omission somewhat by adopting a policy akin to the swaps exemption, but might be interpreted not to prohibit manipulating the price of exempt instruments. The attached revised version of H.R. 2374 attempts to address those technical issues in H.R. 2374. The revised version also would preserve the rights of any parties injured by fraud or manipulation in connection with exempt instruments to bring private damage actions.

As an alternative to H.R. 2374, the CFTC could adopt a regulation that prohibits fraud and manipulation in connection with any transaction that is otherwise generally exempt from the CEA. The Board of Trade also would support that direct approach to maintaining the core protections in the CEA.

<u>**Other Core CEA Protections -- Clearing**</u>

Neither the CFTC exemptions adopted to date nor the provisions of H.R. 2374 address another apparent oversight in the exemptive area -- the role of clearing. Clearing is the process for matching trades and removing credit risk for the parties to a trade (the risk that a losing party to a trade will not pay the winning party).

Clearing is another core protection of the CEA, as the CFTC recognized at its inception. In 1976, the CFTC proclaimed that unless a proposed new futures contract was subject to an acceptable clearing system, that new contract would be found to be "contrary to the public interest" and therefore unlawful. CEA §5(8). The CFTC even has described clearing to be the "essence of the integrity of a futures contract." 41 Fed. Reg. 40093 (1976).

Although the Commission historically had found the **absence** of clearing to be "contrary to the public interest," in the recent swaps and energy contract exemptions, the CFTC found the **absence** of clearing to be "consistent with the public interest" for those exempt transactions. Perhaps lawyers can perceive a logical thread in those policy judgments but I must say, as a businessman, I find that kind of agency inconsistency to be difficult to fathom.

Compounding the puzzling nature of the CFTC's policy toward clearing, both the Federal Reserve Board and the Securities and Exchange Commission supported expanding the CFTC's exemption in the hope that clearing systems for exempt derivative instruments would strengthen financial protections for those instruments. Yet the CFTC refused to allow clearing for exempt instruments, a process the Commission previously had viewed to be mandated by the public interest.

In recent weeks, many articles have appeared bemoaning the extent of credit risk OTC derivative instruments now face. One guest editorial in the Wall Street Journal even suggested that we, the taxpayers, are now underwriting that risk since, in the absence of clearing, the U.S. government acts as the guarantor for all off-exchange derivative instruments for U.S. financial institutions. Allowing clearing of exempt instruments would strengthen the existing OTC markets and remove the cloud of financial exposure now facing the taxpayers. For these reasons, this Subcommittee should direct the CFTC to remove the ban on clearing of exempt instruments.

Fair Competition

As you know quite well, Mr. Chairman, Congress recognized in 1992 that exchange markets compete with OTC dealer markets. Competition of this kind is healthy, as long as it is fair. Congress therefore required the CFTC to promote "fair competition" between OTC and exchange markets in exercising its exemptive powers. The 1992 Conference Committee specifically directed the agency to apply its exemptive powers in a "fair and even-handed manner to products and systems sponsored by exchanges and non-exchanges alike." The CFTC's exemptive actions, thus far, have violated that directive.

Twice the exchanges have asked the CFTC to level the exemptive playing field and allow exchange and OTC markets to participate in class exemptions on a "fair and even-handed" basis. Twice the CFTC has rejected those requests by precluding exchanges from offering exempt instruments.

The CFTC's policy is both inconsistent with the agency's 1992 mandate and unwise. Exchange trading would offer all market users the benefits of price transparency, market liquidity and clearing. By affording market users more exempt instruments to choose from, the CFTC would enhance competition for, and reduce the cost to market users of, risk management services that are essential to all businesses in our economy.

In 1992, Congress understood the benefits of, and mandated the CFTC to promote, fair competition. The CFTC's exemptive actions have ignored those congressional findings. In any legislation you adopt, this Subcommittee and Congress should reinforce the CFTC's fair competition mandate in a manner the agency can not ignore.

Professional Trading Market Exemption

Since Congress granted the CFTC exemptive powers, the Board of Trade has studied carefully the exemptions the agency has granted, the rationale for those exemptions and the proposed exemptions submitted by others. Based on that review, the Board of Trade has decided to file with the CFTC an exemptive request for what we call a "Professional Trading Market." Under this proposed exemption, exchanges would be able to offer those sophisticated and well-capitalized institutions that use the OTC markets the benefits of transparent pricing (through floor or electronic trading), legal certainty, and reduced credit risk, all at low regulatory cost. Thus, the proposed exemption would promote responsible innovation by exchanges and other boards of trade while promoting fair competition between exchanges and OTC markets -- the very purposes Congress cited when it enacted Section 4(c) of the Act.

Subject to certain conditions, a Professional Trading Market would be exempt generally from CFTC regulation. Those conditions would be

> 1) only professional traders (no small, retail public customers) could trade on this market;

2) the board of trade operating the market would have to notify the CFTC when the market begins operations;

3) all market participants would be subject to special fraud and manipulation prohibitions as well as private damage actions; and

4) all trades must be submitted to a CFTC-approved clearing system.

The proposed "Professional Trading Market" exemption is "consistent with the public interest" as required under Section 4(c) of the Act. In applying that standard, the CFTC twice has found that any regulatory "concerns regarding financial integrity and customer protection" are "addressed . . . through the requirement that [exempt transactions] may only be entered into or transacted on behalf of" large institutions and other professional traders. The proposed exemptions would meet the public interest test in exactly the same way.

In fact, the proposed "Professional Trading Market" exemption has considerably stronger regulatory safeguards than the exemptions the CFTC has approved to date. In particular, the notification, private right of action and clearing conditions of the proposal make it tighter from every regulatory perspective than other exemptions the CFTC has adopted. The Board of Trade therefore will ask the CFTC to approve this proposed exemption expeditiously.

Conclusion

Mr. Chairman, like you and the members of this Subcommittee, the Board of Trade wants both the exchange and OTC markets to prosper. One noted industry expert has observed that in today's financial world, exchange and OTC markets both compete with and complement each other. The Board of Trade therefore has a strong interest in seeing OTC markets thrive in a secure environment so long as the competition between exchanges and OTC markets is fair and open. The policies I have outlined today would serve to make that objective a reality. The Board of Trade looks forward to working with this Subcommittee under your leadership toward implementing those policies.

[REVISED]

H.R. 2374 -- To amend the Commodity Exchange Act to ensure the continued application of the Act's antifraud and antimanipulation provisions.

The Commodity Exchange Act (7 U.S.C. 1, *et seq*) is amended by adding to Section 4 the following section (e):

(1) It shall be unlawful for any person, directly or indirectly, in or in connection with any agreement, contract or transaction that is exempt from Section 4(a) of the Act pursuant to an exemption adopted by the Commission under Section 4(c) of the Act or is exempt from any Commission-imposed contract market designation requirement for options, or any similar requirement, pursuant to an exemption adopted by the Commission under Section 4c of the Act --

(A) To cheat or defraud or attempt to cheat or defraud any other person;

(B) To make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof; or

(C) To deceive or attempt to deceive any other person by any means whatsoever.

(2) In or in connection with any agreement, contract or transaction that is exempt from Section 4(a) of the Act pursuant to an exemption adopted by the Commission under Section 4(c) of the Act or is exempt from any Commission-

imposed contract market designation requirement for options, or any similar requirement, pursuant to an exemption adopted by the Commission under Section 4c of the Act, it shall be unlawful for any person to manipulate or attempt to manipulate the price of

(A) any such agreement, contract or transaction or

(B) any commodity in interstate commerce or any contract of sale of a commodity for future delivery traded on or subject to the rules of any contract market.

(3) Any person violating subsections (1) or (2) of this Section shall be disqualified from relying upon any exemption granted by the Commission under Section 4(c) or Section 4c of the Act.

(4) In accordance with the procedures set forth in Section 22 of the Act, any person injured by a violation of subsections (1) or (2) of this Section may bring a right of action for actual damages suffered as a result of that violation against any person who committed or aided and abetted that violation. This right of action shall be the exclusive remedy available under the Act to any person injured by a violation of subsections (1) or (2) of this Section.

(5) The proscriptions in subsection (1) of this Section shall not apply to an exemption for any agreement, contract, transaction, or person (or class thereof) to the extent that such agreement, contract, transaction, or person (or class thereof) is or will be subject to federal securities or banking laws that provide comparable antifraud protection, as determined by the Commission."

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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STATEMENT OF WAYNE KLEIN

Securities Bureau Chief
State of Idaho

on behalf of the
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

before the
SUBCOMMITTEE ON ENVIRONMENT, CREDIT,
AND RURAL DEVELOPMENT
Committee on Agriculture
U.S. House of Representatives

"H.R. 2374, regarding the application of the Commodity Exchange Act's anti-fraud and anti-manipulation protections"

June 30, 1993

Mr. Chairman and Members of the Subcommittee:

My name is R. Wayne Klein. I am Chief of the Idaho Securities Bureau and a member of the board of directors of the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level. NASAA and its members work closely with the Commodity Futures Trading Commission (CFTC) and National Futures Association (NFA) in combatting commodity-related fraud. On behalf of NASAA, I appreciate the opportunity to appear before you today.

INTRODUCTION AND OVERVIEW

NASAA is pleased to lend its strong support for the immediate adoption of H.R. 2374, legislation which would amend the Commodity Exchange Act (CEA) to ensure the continued application of the Act's anti-fraud and anti-manipulation protections, even in those instances where exemptions from regulatory oversight otherwise are granted. NASAA shares the serious concerns, and frankly, the frustrations that have been expressed with respect to the CFTC's recent order exempting certain energy contracts from most of the provisions of the Commodity Exchange Act, especially the Act's anti-fraud and anti-manipulation provisions.

In addition to expressing support for immediate attention to the issue before the Subcommittee today, I also would like to take this opportunity to discuss what we believe is a more general (and disturbing) trend at the CFTC -- that is, increasingly inadequate and lax oversight of the commodities markets.[1] In fact, the CFTC's order with respect to exempting certain energy contracts is just the latest example of what perhaps may be best characterized as the agency's "reluctance to regulate," even in the face of blatant threats to investors and the integrity of the markets. Worse yet, the Commission has vigorously guarded what it believes to be its "turf," only to turn around and severely limit its own regulatory role. This minimalist approach seems to be one of "we won't police the area but we don't want anyone else to either." It is our hope that such an approach will not persist, and that instead, the Congress and the Clinton Administration will use their considerable authority to re-direct the agency's effort with a clear sense of its original mission and purpose.

[1] The Association wishes to make a clear distinction between its concerns about the philosophy and actions of Commission leadership in recent years and the Commission's hard-working staff, which deserves credit for its investor protection efforts.

OVERSIGHT OF THE FUTURES MARKETS

The futures markets today are recognized at home and abroad as a vital part of the financial services industry. They provide the critical functions in our economy of risk shifting, liquidity for commodity producers, and price discovery. The regulatory environment in which the futures markets operate should recognize and compensate for the features unique to them, including: (1) participation by a relatively small number of smaller traders; (2) the close relationship between some futures and equity markets; (3) the "zero-sum" nature of the market in which every dollar in profit to one person represents a dollar in losses to another person; and (4) exclusive regulatory jurisdiction by a single agency, the federal Commodity Futures Trading Commission.

Under the authority of the Commodity Exchange Act, the CFTC is charged with overseeing the futures markets. In adopting the Act, Congress described its remedial purpose:

> *The fundamental purpose of the Commodity Exchange Act is to ensure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize markets to the injury of producers and consumers and the exchanges themselves.*[2]

Courts which have examined the CEA have repeatedly cited the legislation's protective purpose.[3] While I recognize that Members of this Subcommittee are well aware of the history and purpose of this nation's commodity laws, I make this point so that you might contrast the recent actions of the CFTC in exercising its new exemptive authority under the Futures Trading Practices Act of 1992 (FTPA) with Congress' original purposes in enacting the CEA.

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[2] See, 7 U.S.C. Section 5; S. Rept. No. 93-1131, 93d Cong., 2d Sess., 1974.

[3] See, e.g., *Commodity Futures Trading Commission v. British American Commodity Options Corp.*, 788 F.2d 92, 94 (2d Cir.), cert. denied, 479 U.S. 853, 107 S.Ct. 186, 93 L.Ed.2d 120 (1986); *Tamari v. Bache & Co. (Lebanon) S.A.L.*, 730 F.2d 1103, 1106 (7th Cir. 1984), cert denied, 469 U.S. 871, 105 S.Ct. 221, 83L.Ed.2d 151 (1984).

The CFTC is the exclusive regulator of futures contracts, options on futures and the organized commodity exchanges (contract markets).[4] As such, if the CFTC fails to assert or exercise its jurisdiction in these areas, other regulators, including state securities regulators, have very limited authority to act. When Congress acted in 1982 to amend the CEA, it included the so-called "open season provision" (Sections 6d and 12e of the CEA), which gave the states new authority to enforce the CEA in federal courts and to move in state court against illegal off-exchange products and operators. These provisions were carefully crafted by Congress and intended to foster a meaningful and effective CFTC-state partnership in the policing of the legitimate and illegitimate marketplace. We are concerned that the CFTC now seems to be taking steps to remove itself from that partnership, leaving the states in the unenviable position of having to move in and clean up the fraud that can develop due in large measure to deregulatory policies. Given the very limited authority of the states under the CEA, the states find such a possibility particularly disturbing. We ask you to consider the potentially devastating effects if oversight of the futures markets is left to the extremely limited anti-fraud powers of the states:

- If the CFTC removes itself from the partnership with the states, it will take with it the extraordinary enforcement powers unique to that agency. At the same time, we would lose the years of expertise that have been built up in that agency;

- Only a federal agency such as the CFTC can move swiftly and effectively to shut down fraudulent operations acting on a <u>nationwide</u> basis;

- It is unreasonable to expect the states to shoulder the burden of acting as the sole enforcer of violations of the laws in this area when the states have no voice in shaping the regulatory policies that may have the effect of allowing these very violations or the effect of <u>increasing</u> the volume of fraud and abuse; and

- It is fundamentally unfair to rely exclusively on the states to police the marketplace when the states have been denied the authority to deter the fraudulent or abusive behavior before it occurs. Is it not better to give law enforcers the power to implement standards that will reduce the incidence of fraud <u>before</u> it occurs. This is exactly the theory underlying the CFTC's current authority to require trading on the exchanges and make it subject to all of the statutory safeguards.

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[4] When Congress adopted the CEA in 1974, it preempted the states from applying their investment laws to persons and transactions deemed to be within the jurisdiction of the Act. In response to the virulent outbreak of commodity-related fraud in the late 1970s and early 1980s, Congress amended the Act in 1982, permitting the states to police off-exchange commodities-related products and those selling them, if such sales are illegal under the CEA. The states also may enforce some provisions of the CEA in federal court.

As a result, I am deeply concerned that during the past several years, the CFTC has embarked on a course of abandoning and repudiating its responsibilities to protect the integrity of the commodity futures markets and those who invest there. The CFTC's action in exempting broad categories of energy products from the anti-fraud and anti-manipulation provisions of the CEA is the most recent, and a most egregious, example of this new course. Without active and vigorous oversight, the markets under the CFTC's exclusive jurisdiction invite fraud and abusive trading.

Further, it would seem that the wiser course would be to adhere to Congressional intent as evidenced by the history of the CEA, and to encourage trading toward the markets, rather than the opposite, as the Commission seems to be doing. Congress has explicitly required that all futures contracts be traded on designated exchanges. This exchange-trading requirement is not the product of some fleeting Congressional whim. Rather, it is the result of more than 70 years of Congressional experience with these markets.

The resulting regulatory framework works rather well in promoting market integrity, providing price discovery of commodities, increasing liquidity in the markets, and reducing the transaction costs of entering into futures contracts. The efficient operation of these markets is vital to the domestic and, indeed, the global economy. NASAA's support for encouraging trading on exchanges centers around two central facts: (1) affirmatively doing so would help avoid market fragmentation; and (2) this type of trading needs appropriate supervision, which is best accomplished by governmental oversight of the exchanges. In the end, these markets are far too important to be entirely overlooked by a vital regulatory agency.

WHAT TYPES OF FUTURES TRADING SHOULD BE REGULATED

Mr. Chairman, as you well know, Congress intentionally has declined to define the term "futures contract" under the Commodity Exchange Act for fear that drawing such a distinction would encourage the proliferation of products and schemes deliberately designed to evade or avoid CFTC jurisdiction. Rather, it has been left to the courts and to the CFTC itself to apply established case law and other tests in determining whether a contract is a "futures" contract for purposes of the Act. In fact, it was only in the Futures Trading Practices Act of 1992 that the CFTC was granted new exemptive authority which frees the agency from having to make the "all or nothing" jurisdictional decisions faced in the past. It was the hope of NASAA that the Commission would assert this new exemptive authority judiciously and prudently in those cases where it was determined that, in so doing, restraints on commerce would be reduced and markets would be permitted to evolve. It was not expected that the authority would be used to alter the Commission's overriding responsibility to protect the public interest.

However, and in retrospect, perhaps the Commission's most recent action should have been anticipated. The agency's track record over the last several years clearly demonstrates a disdain for using its regulatory powers to conduct oversight of unusual or innovative products. It is instructive to examine the direction in which the CFTC has moved in recent years. I, personally, have observed the CFTC's reluctance to exercise the very authority it has fought so hard to reserve for itself.

Paragon Investment Company (P.I.E). In 1985, I learned about a gold and silver margin investment scheme being offered in Idaho by California-based Paragon Investment Company, also known as P.I.E. In inquiring about the investment, I was falsely told by an account executive that if I invested, there would be no exit charges, no interest fees, no charges for the unpaid balance, and that I could liquidate the contract whenever I chose. The sales pitch included the all-too familiar assurances: the price of silver would shoot up the next day because OPEC ministers were expected to announce that they were taking action to shore up the price of oil, thus causing the price of silver to increase; the low price of silver made it almost impossible to lose; the price was fantastic and I should buy now; most of the salesman's clients have experienced big profits; the big brokerage houses had put out the biggest buy signals in a long time and I would be in a safe position; the price of silver would shoot up astronomically due to unrest in South Africa; and I would be dealing with a good, clean, legitimate company. An investigation conducted by the Idaho Securities Bureau uncovered numerous false statements and misrepresentations and exposed this as a fraudulent scheme.

I welcomed this opportunity to accept the CFTC's oft-repeated offer to bring joint enforcement actions with the states. At the time, I was a Deputy Attorney General for the State of Idaho, and I drafted a joint complaint to be filed in federal court on behalf of Idaho and the CFTC against Paragon. Fortunately, the Paragon scheme was structured in a way which allowed us to bring an action under the SEC laws, because after six months of contradictory answers from the CFTC on whether they would join us in a joint action, I gave up on the idea of acting together. Instead, I filed an enforcement complaint on behalf of the State in state court under the Idaho Securities Act. During the six months that we waited for the CFTC to get back to us, the fraud continued to prosper.

Ironically, our action attracted substantial print and television media attention in Los Angeles. Reporters asked the then-Los Angeles Regional Director of the CFTC for comments about our suit. His response was that the CFTC was conducting its own investigation of Paragon. Indeed, a few weeks later, the CFTC did file its own suit in federal court.

The State of Idaho received the injunction it sought. So did the CFTC, which additionally obtained a receiver and a temporary restraining order. While our action halted perpetration of the fraud in Idaho, only the CFTC's action had the effect of stopping the practices nationwide. Cooperation here would have made great sense. Instead, we had two duplicative actions going their own way, piling up expenses, and using far more valuable time than would have been necessary had there been even elementary cooperation.

In the decision in this CFTC action, the court reaffirmed the characterization of a futures contract, basing its rationale on the landmark Ninth Circuit decision in CFTC v. Co-Petro Marketing Group,.[5] Co-Petro held, in part, that futures contracts were characterized by standardization of contract terms and the existence of conditions which facilitate the formation of off-setting or liquidating transactions (allowing for non-delivery).

As I have stated, Congress deliberately left open the question of the definition of a futures contract so that the courts and the CFTC would have maximum flexibility to apply the CEA to all types of violative behavior. In 1990, however, and ironically, this flexibility resulted in the Commission's rebuke of a federal Court. In Transnor (Bermuda) Ltd. v. BP North America Petroleum, et al,[6] the federal district court for the Southern District of New York on April 18, 1990, ruled that certain oil contracts were indeed futures contracts and subject to the provisions of the CEA, which requires that futures trading be conducted on a designated exchange. This decision left participants in the Brent crude oil markets in a state of uncertainty as to the legality of the transactions in which they were engaged.

The CFTC Responds to Transnor. The CFTC's reaction to the Transnor decision was quick, but beyond its authority and misguided. In its attempt to calm oil traders, producers, and purchasers, the CFTC went too far. After the Transnor decision was issued, the Commission promptly released an advisory indicating that the agency was dedicated to maintaining access to the Brent market. The Judge in New York was sent a letter and within a day was provided with a copy of the advisory by the CFTC's general counsel. After this rather unusual signal to the Court, the Commission, less than a month after the Transnor case was settled, voted to authorize the staff to complete a draft of a legal interpretation. Shortly thereafter, another Commission advisory announced that a draft legal interpretation was available upon request from the general counsel and that comments on it would be received over a two week period. In short, the public, outside of the special interest lobbyists, had little time to comment or otherwise offer its views. Two months later, on September 25th, the final interpretation was published in the Federal Register, having been adopted by a 3 - 1 vote.

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[5] 680 F.2d 573 (9th Cir. 1982).

[6] 738 F.Supp.1472 (S.D.N.Y. 1990).

The Commission's action here had three major flaws:

- o The CFTC presumed to overrule the federal district court in New York in the Transnor case by the issuance of its own interpretation;

- o The CFTC went beyond its legal bounds by dealing with a perceived problem through a legally obscure procedure. In effect, the CFTC attempted to change the law through a legal interpretation, rather than following the law determined by Congress assume; and

- o The Commission unilaterally announced a new set of criteria as to what distinguishes a futures contract from a forward contract. These new criteria were contrary to those set down by the courts and the CFTC in previous actions.

The State of Idaho submitted a comment letter to the CFTC urging restraint:

> *The State's foremost concern is that an exclusion as described above, unless narrowly drafted, could have far-reaching and objectionable effects. As a regulatory agency with responsibility for investor protection, our task would be made infinitely more difficult by [a] broad interpretation which did not consider the enforcement ramifications of this issue.*[7]

The State urged the CFTC to carefully limit the scope of the exclusion contemplated in the interpretation to "apply only in situations where a commercial party is purchasing for its own use or inventory" and to limit the exemption to the Brent contracts. We cautioned the Commission that a broadly drawn exclusion would legitimize fraudulent practices then in use by some commodity firms.

It appears that the CFTC perceived itself to be between the proverbial "rock and a hard place". It wanted to clarify the law with the goal of calming traders in the Brent Oil market. On the other hand, it lacked the flexibility under the law to grant any exemption.

The CFTC's solution was a bad one. It decided to "overrule" the Transnor court and, in effect, create an exemption. Since it lacked exemptive authority, however, it chose to alter the traditional definitional elements of a futures contract. The Commission arbitrarily announced, under the guise of merely "interpreting" the law, that a new standard now existed. As a result, the CFTC interpreted away its own jurisdiction and disclaimed authority over a broad category of products. The Commission seemed not to care that by changing the definition of a futures contract, the new criteria threatened to shield

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[7] A copy of the June 8, 1990, comment letter is attached. Unfortunately, many of our fears later were realized.

fraud in the trading of other commodities -- a hefty price to pay for helping the oil companies.

In reality, the Statutory Interpretation that was adopted was a broad pronouncement of new policy. This was despite a strongly worded 27 page dissent by then-Commissioner Fowler West.[8] The irony of the Statutory Interpretation was that the CFTC usurped judicial and Congressional authority -- then used that putative authority to deny itself jurisdiction.

Unfortunately, since the CFTC has exclusive jurisdiction in this field, the states have limited power to use the "open season" provision under the CEA to move against and prevent fraudulent activities. We are compelled to live with these federal policies. If the CFTC grants an exemption, ruling that the CEA does not apply to certain transactions or products, it then also denies the states the ability to use the CEA to stop fraud in sales of these products. Our only hope was that Congress would remedy the problem or that the courts would recognize that the CFTC action exceeded its authority -- and disregard the Statutory Interpretation. We were disappointed in the latter.

A-Mark Precious Metals. Keith Bybee, a sole proprietor buyer and seller of gold and silver in Boise, began buying precious metals from A-Mark Precious Metals for resale to customers. A-Mark convinced Bybee to open a margin account that consolidated money belonging to him and his customers. A margin account such as Bybee's allowed for substantial leverage in his speculative trading of precious metals. All trading was required to be done in Bybee's name, not that of his customers. Some 95% of the subsequent purchases were offset rather than resulting in delivery of metals.

By 1986, Bybee had suffered huge losses and A-Mark liquidated his account. As a result, over one hundred small investors lost $2 million. Mr. Bybee was convicted in state court of fraud and went to prison. In addition, my office obtained a court imposed judgment and injunction against him. However, investors were left without restitution.

Both the bankruptcy trustee and the State of Idaho filed suit against A-Mark alleging that its dealings with Bybee, while he was using customer monies, constituted the sale of illegal off-exchange futures contracts. Our goal was to go after the commodity firm which made Bybee's scheme possible in the first place. Despite our prior experience with Paragon Investments, we still wanted to bring a joint enforcement case with the CFTC under the 1982 amendments to the CEA. I received informal assurances from staff in the CFTC's Division of Enforcement that they concurred with our legal analysis. Unfortunately, the Commission would not respond to our request. Finally, we gave up on a joint action and filed suit alone under the authority granted to the states in Section

[8] Commissioner West's dissent from the Statutory Interpretation was refused publication by the CFTC at the time of adoption of the Statutory Interpretation.

6d of the CEA. Our suit represented the first time that a state had acted alone to enforce the CEA in federal court.

The suit by the bankruptcy trustee went to trial first. The district court, applying the factors identified in Co-Petro and similar cases, held that the transactions were entered into for speculative purposes with no expectation that delivery would occur and found that all the elements of futures contracts existed but one -- the public was not involved. With that conclusion, he ruled that the investments being sold were not futures contracts.

The district court's decision was appealed to the Ninth Circuit Court. Since it was this same court that had decided both Paragon and Co-Petro, we had high expectations that the court would find that a futures contract existed and perhaps even take the opportunity to rule that the CFTC's Brent Oil Statutory Interpretation was ultra vires. We were wrong.

During the appeal, the State of Idaho submitted an amicus curiae brief to the court arguing for continued application of the criteria set forth in the long line of cases defining futures contracts. We encouraged the CFTC also to file an amicus brief. Its brief, however, was limited to informing the court that public participation was not a necessary element of a futures contract. In the meanwhile, we were advised that the CFTC's general counsel had been actively soliciting amicus briefs opposing the position of the State and the bankruptcy trustee that futures contracts were involved. Three parties filed such briefs.

Relying heavily on the recently promulgated CFTC Statutory Interpretation, the Court of Appeals issued an astounding opinion.[9] Incredibly, it ruled:

- The A-Mark contracts were simultaneously futures contracts under the CEA and forward contracts excluded from the CEA, pursuant to the Brent Statutory Interpretation;

- That great deference should be given to the Commission's interpretation of the CEA, even if it departs from well established case law; and

- The CFTC's "innovation" in its treatment of delivery obligations was adopted for the A-Mark transactions, and so long as offsetting transactions are "separate, individually negotiated, new agreements," there is no standardization of contracts such that the instruments are covered by the statute.

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9 Krommenhock v. A-Mark Precious Metals Inc.; In Re Bybee, 945 F.2d 309 (9th Cir. 1991).

Heretofore, the terms, futures contracts and forward contracts, had been mutually exclusive. Contracts were either subject to the provisions of the CEA or excluded from the CEA. This new decision, however, created an especially pernicious effect. By first defining these contracts as futures contracts, the CFTC gained exclusive jurisdiction. State laws generally would not apply. The securities laws cannot be used to proscribe conduct. But, by then also finding them to be forward contracts, the CFTC is itself deprived of jurisdiction. The A-Mark court was overwhelmingly successful in ensuring that there will be absolutely no regulatory oversight of these contracts sold by A-Mark or of any contracts structured in a similar manner.

This decision wrought a second major benefit for fraudulent commodity investment schemes. As a result of this case, the concept of offset conducted off of an exchange -- which was traditionally the touchstone of an illegal off-exchange futures contract -- now is legitimized. All that a scam must do is assert that all offsetting transactions are separately negotiated and they will be unregulated forward contracts.

These results are directly contrary to the regulatory and legislative history of the CEA. It may have a direct effect on the enforcement efforts of the CFTC. Since the A-Mark decision, there seems to me to have been a significant decline in the number of "off-exchange" enforcement cases initiated by the CFTC. State regulators also have been impaired. The fears expressed in our June 1990 letter to the CFTC were all fulfilled -- and more.

FUTURES TRADING PRACTICES ACT of 1992

We had high hopes for a reversal of this trend with the passage of the Futures Trading Practices Act of 1992 (FTPA). New section 4(c) of the CEA specifically authorizes the CFTC to grant exemptions that meet a set of very narrow and stringent conditions. NASAA generally supported the granting of this authority as it would enable the Commission to authorize certain isolated trading without also sanctioning illegal conduct that mimicked the outward trading styles of the exempted trades.[10] It was our expectation that the exemption would be considered only for those parties that requested an exemption and demonstrated sound reasons why the CEA should not apply. This would eliminate the need continually to contort the definition of a futures contract in order to provide needed relief, as was the case in the Brent Statutory Interpretation.

[10] See, November 6, 1991 letter from then-NASAA President Lewis Brothers, Jr. to Senator Patrick Leahy regarding the Conference Committee's consideration of CFTC Reauthorization Legislation.

In addition, the Conference Report of the FTPA attempted to repair some of the damage caused by the A-Mark decision by making legislative policy clear that:[11]

- o Products cannot be simultaneously futures contracts and forward contracts;
- o The Co-Petro standards still should be used against fraudulent commodity schemes; and
- o States and other federal authorities are not precluded from asserting jurisdiction over forward contracts, even if the CFTC lacks jurisdiction.

CFTC ENERGY EXEMPTION

The CFTC quickly demonstrated that it did not view its exemptive authority granted under the FTPA as being limited in scope or to be used sparingly. Neither did it accept the admonitions from the FTPA Conference Committee that the expansive definitions adopted in A-Mark should be revisited with special consideration for its public policy implications.

NASAA had hoped and even expected the CFTC to use its new exemptive authority to revisit the Brent Statutory Interpretation, making it more narrow -- especially in light of A-Mark. Indeed, just the opposite has occurred.

On April 13th, the CFTC voted 2-1 to exempt certain energy products from its jurisdiction. The exemption, as adopted, is extraordinarily broad. It covers transactions, products and parties who never even requested application of the exemptive authority. It uses broad language that I feel undoubtedly will assist fraudulent operations. In an unprecedented move, the divided Commission proclaimed it did not even preserve for itself antifraud jurisdiction.

Commissioner Sheila Bair dissented from adoption of this Rule, saying in part:

> *In my view, the final order, by its terms, is not limited to forward contracts traditionally excluded from the jurisdiction of this agency. Rather, it goes significantly beyond the forward contract exclusion and extends to transactions which could very well meet the criteria for illegal off-exchange futures contracts traditionally applied by this agency and the courts. I believe that exempting such transactions from statutory provisions as basic and central to our regulatory scheme as Sections 4b and 4o is a serious misapplication of our new exemptive authority, and sets a dangerous*

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[11] See Futures Trading Practices Act of 1992, Conference Report, U.S. House of Representatives, 102nd Congress, 2d Session, Report 102-978, October 2, 1992, page 72.

precedent.

As this Subcommittee learned in its hearing on April 28, 1993, the CFTC's Division of Enforcement and its Division of Trading and Markets recommended against such a broad exemption while abdicating anti-fraud jurisdiction. If the views of these two divisions, which have substantial expertise as well as the experience gained from real world application of the law, are not heard, I fear that CFTC policies in general, and this exemption in particular, have lost any relation to reality. Thus, it seems that deregulatory theory alone drives Commission action.

A more serious effect of this exemptive rule is to discourage the use of reasonably regulated and liquid U.S. futures exchanges. When the Commission encourages off-exchange or off-shore trading in place of trading on the regulated exchanges, by granting wholesale, broad exemptions, it cannot help but speed migration of trading from the exchange floor. Indeed, the exchanges even can be beneficiaries of this regulatory abdication. They now can trade off-exchange without government regulations -- the same regulations deliberately imposed by Congress as a result of fraudulent practices and which are intended to protect traders, investors, and hedgers.

Why should we care? Who will complain? The beneficiaries of this largess include the CFTC, large traders, the exchanges (to the extent that they take advantage of these off-exchange opportunities) and, most sadly, promoters of fraudulent schemes who now can structure their investments a certain way and operate with impunity.

Those who will suffer from this result are those whose voices are not being heard and whose interests are not being protected by the CFTC:

- Individual investors victimized by fraudulent schemes now ignored by the CFTC;

- Hedgers and speculators who trade on the regulated exchanges and now will find less liquidity in their markets, more volatility, less efficient price discovery (as fewer trades are reported on the organized markets), and an increased risk of manipulated prices;

- The U.S. economy which relies on the organized exchanges for price discovery of commodities, ample future supplies as indicated by commodity price directions, and a source of actual commodities for delivery; and

- Regulators and other law enforcement authorities who have reduced abilities to assert jurisdiction and apply the law to off-market trading -- both legitimate and illegitimate.

Sadly, those groups who will be most disadvantaged by this current action probably do not yet know the deleterious effects they will suffer as a consequence.

RECOMMENDATIONS

We cannot emphasize enough the seriousness of our concern about the CFTC's actions. This broad exemption is particularly intolerable with the disclaimer of anti-fraud jurisdiction. The course must be reversed. To do so, NASAA would offer the following recommendations:

- o Prompt passage of H.R. 2374. This bill is absolutely necessary to mandate preservation of anti-fraud authority both retroactively and prospectively;

- o The CFTC should be directed to withdraw the 1990 Brent Statutory Interpretation;

- o Congress should consider requiring the CFTC to provide a reasonable, scheduled review of this latest exemption then require each entity seeking use of the exemption to make a separate, publicly available application for exemption. Each application should be accompanied by an explanation as to how the participant and the contemplated transactions satisfy the criteria set forth in the Futures Trading Practices Act.

- o The CFTC must take great care in granting exemptions on a broad, generic basis without knowing who will be taking advantage of the exemptions. This may help reduce the chance that the exemptions would be used by crooks. It will also provide information to the CFTC about off-exchange trading with which to evaluate the effects of the exemption. Moreover, it makes publicly available such economic factors as the volume of, prices of, and parties engaging in, such trading;

- o Congress should require the CFTC to embrace the policies set forth in the FTPA Conference Report regarding the distinctions between futures and forward contracts, the continued validity of prior caselaw establishing the futures contract definition, and the jurisdiction of other regulators;and

- o Congress should consider prohibiting the CFTC from granting any exemption from its oversight for transactions which are virtually clones of products trading on regulated exchanges. This will prevent migration of trading from the exchanges and the omission of trading data from the financial markets.

NASAA has sent a letter to President Clinton expressing concern over the direction of the CFTC.[12] Our letter urged the President to move quickly to fill the vacancies at the CFTC. At the very least, we recommended that President Clinton immediately seek the CFTC's agreement to make no further policy changes, such as this, until a full contingent of commissioners has been approved -- individuals who will represent the views of this Administration. We respectfully urge this Subcommittee to support the same goals.

CONCLUSION

NASAA appreciates the opportunity to present its views on this very important issue. We commend you for taking steps to halt this regulatory abdication by an agency which was entrusted with exclusive jurisdiction. We hope that the oversight process by Congress will help prevent any further damage by this agency.

If the CFTC is allowed to continue on this path, it may be a very short path. If this continues and only three more exemptive proposals are adopted -- one for financial instruments, one for precious metals, and one for agricultural products -- there will be little left to regulate. We can then disband the agency. At least then we could stop what has become a cruel hoax on the American public -- that the markets are well protected and that the government is acting in the best interests of the general public.

As the House Committee on Agriculture recognized in 1932:

> *So long as these markets are to be regulated as public markets and so long as they operate under the apparent supervision of the Federal Government, it seems proper that such supervision should protect the rights of customers as fully as possible.*[13]

(Attachments follow:)

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[12] A copy of the letter dated June 2, 1993 is attached.

[13] H.R. Rep. No. 1551, 72d Cong., 1st Sess. Section 3, (1932).

72-584 O - 93 - 6

NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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ATTACHMENT

June 2, 1993

Honorable William J. Clinton
The President
The White House
Washington, DC 20500

Dear Mr. President:

On behalf of the North American Securities Administrators Association, [1] we urge that prompt attention be focused on filling vacancies at the Commodity Futures Trading Commission (CFTC). There are currently, as a practical matter, three vacancies in existence; although the position of acting-chairman presently is filled by a commissioner whose term has expired. The acting-chair has indicated that he will depart in August, 1993.

The CFTC has a critical regulatory role, not only because it oversees the large futures industry, but also because it has the exclusive regulatory authority over futures contracts, unlike the regulatory scheme for the securities industry, where the states and the Federal government share oversight duties. As a result, the CFTC alone is responsible for the approval of innovative financial products, the curbing of destructive fraudulent trading schemes, and the promotion of stability and liquidity in the trading of financial derivatives.

Mr. President, the CFTC has the opportunity to promote innovation, but there must be a balance struck between promoting financial innovation and safeguarding the public. A strong CFTC is especially desirable because of its oversight of stock index futures and various forms of program trading, which impact the equity markets.

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[1] In the U.S., the North American Securities Administrators Association (NASAA) is the national voice of the 50 state agencies responsible for investor protection and the efficient functioning of capital markets at the grassroots level.

The CFTC's role in safeguarding the integrity of the commodity futures market should not be underestimated. One of the CFTC's primary roles is to assure that there is no manipulation of prices on the futures exchanges. Any dysfunction of the commodity futures markets could have a devastating and global impact on market prices for a wide range of commodities. Finally, while recognizing that over-regulation can hurt the marketplace, great harm also can come from too little regulation.

Mr. President, recent actions taken by the CFTC have caused great concern among state regulators and within Congress. Under exemptive authority[2] provided in its most recent reauthorization, the CFTC, on April 13, 1993, completely dismissed from oversight and regulation a large number of energy products. These products are believed by many to be futures contracts, which should be traded on a futures exchange. While some use of the exemptive authority in this area was encouraged by Congress in the CFTC's reauthorization, the CFTC surprised most observers, including the states and its own Division of Enforcement, by going so far as to exempt these products from even its anti-fraud rules. In short, the CFTC appears to have served notice, in advance, that it will not intervene even if faced with patently fraudulent activity in this area.

The CFTC's recent action greatly expands a controversial legal interpretation issued by the CFTC in 1990, involving the Brent Oil markets.[3] That action directly opened the door to potential abuse

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[2]NASAA supported this grant of authority as a means of permitting appropriate, narrow exemptions in contrast to the prior pattern of wholesale abdication of its responsibilities. However, this new power is being badly misused.

[3]In September of 1990, the CFTC issued a statutory interpretation tailored to protect oil companies involved in the so-called Brent Oil market. The U.S. District Court for the Southern District of New York had found Brent Oil contracts to be illegally traded futures contracts. The CFTC's interpretation, which passed by a 3 to 1 vote, essentially purported to overrule the court decision. The interpretation declared the Brent contracts to be forward contracts, not futures contracts, by substantially revising the definitional criteria of what constitutes a forward contract and a futures contract under the Commodity Exchange Act.

Honorable William J. Clinton
The White House
June 2, 1993
Page 3 of 4

of consumers.[4] Many states are quite concerned that the exclusive jurisdiction enjoyed by the CFTC, coupled with the CFTC's continuing rush toward deregulation, makes it very hard to provide adequate consumer protection in the commodity futures area.

The vote at the CFTC to grant this broad exemption was 2 to 1. That controversial action led to a hearing by a subcommittee of the House Agriculture Committee, chaired by the Honorable Glenn English, who expressed great concern at the deregulatory recklessness displayed by the CFTC. Mr. English stated at the hearing that the CFTC's action went beyond the authority granted by Congress. He added, "of the 18 years I've been in Congress, this is the most irresponsible decision I've come across."

The states feel that the opportunity to appoint three members to the CFTC should be taken as soon as possible. In particular, a chairman should be nominated without further delay. Special attention should be given to nominating individuals who are dedicated to protecting the public and to providing a proper regulatory balance.

Over the past few years, the states have seen their relations with the CFTC gradually improve, but the recent trend at the CFTC has caused considerable concern. The states have been a willing participant with the CFTC's Advisory Committee on CFTC-State Cooperation, but changes of commissioners at the CFTC have rendered that committee inactive. Our concern is that a lack of action in

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[4]Relying heavily on the CFTC's Brent interpretation, the Ninth Circuit Court of Appeals in California, in 1991, declared that certain precious metals transactions were both forward and futures contracts. This meant that they were subject to the exclusive jurisdiction of the CFTC-- and thus no other regulator could assert jurisdiction. Incredibly, it also meant that it was exempt from CFTC oversight. As a result, no regulatory authority could assert jurisdiction. This ruling thwarted the State of Idaho's efforts to stop what it felt to be a precious metals scam against its citizens which has resulted in the loss of three million dollars.

filling these vacancies will cause a further deterioration at the agency, which is the sole regulator of a large, and oftentimes, volatile futures industry. It is that volatility, combined with the importance of the futures markets, that demands competent and dedicated commissioners.

Respectfully, NASAA requests that you fill these CFTC vacancies with individuals whose goal it is to judiciously regulate, with an appreciation for the primary purpose of the CFTC, protecting the users of the futures markets.

We pledge our full assistance to you as you deal with the financial regulatory area. The executive director of NASAA, Fowler West, just completed two terms as a CFTC Commissioner. His leaving the CFTC greatly reduced the CFTC's focus on investor protection at the commissioner level. This situation needs to be addressed by filling these three vacancies with commissioners who believe in investor protection. NASAA looks forward to your appointments and to working closely with a restored CFTC.

Sincerely,

Barry C. Guthary
Barry C. Guthary
President

Craig A. Goettsch
Craig A. Goettsch
President Elect

14228

CECIL D. ANDRUS
GOVERNOR

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BELTON J. PATTY
DIRECTOR

ATTACHMENT____

June 8, 1990

Wendy L. Gramm
Chairman
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D. C. 20581

Re: CFTC Policy Interpretations on Transnor

Dear Chairman Gramm:

The State of Idaho Department of Finance ("State") wishes to express to you the serious reservations it has concerning proposed CFTC action in the wake of the Transnor (Bermuda) Limited v. BP North America Petroleum, et al., 86 Civ. 1493 (WCC) (S.D.N.Y.) ("Transnor") decision.

Our understanding is that the Commission intends to issue an interpretation of the Commodity Exchange Act ("CEA") concluding that the 15-day Brent contracts fall within the "forward contract" exclusion contained in Section 2(a)(1)(A) of the CEA. This conclusion is based upon representations to the Commission staff that the 15-day Brent contracts are not offered or sold to the general public, and are negotiated transactions between commercial parties, each of whom is able to make or take delivery of Brent crude oil.

The State's foremost concern is that an exclusion as described above, unless narrowly drafted, could have far-reaching and objectionable effects. As a regulatory agency with responsibility for investor protection, our task would be made infinitely more difficult by an broad interpretation which did not consider the enforcement ramifications of this issue.

As you may know, the State of Idaho currently has a case pending in the U. S. District Court for the District of Idaho, State of Idaho v. A-Mark Precious Metals, Inc., et al., Civil No. 89-1055, which states a claim under the CEA. A decision on the futures contract issue is imminent. Central to this case is a determination as to whether the transactions between A-Mark, a

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precious metals wholesaler, and its customer, a precious metals retailer, were off-exchange futures contracts. Of concern is the fact that the retailer acted as a middleman or "broker" for A-Mark to facilitate speculation by individual customers in the metals markets. A-Mark also acted as an exchange in offsetting and clearing the various long and short trades. Because none of the regulatory protections of the CEA were in place, over a hundred small investors lost approximately $2 million.

A-Mark knew that individual investors were participating in its margin trading program and apparently encouraged the practice. Moreover, we disagree that the "Mom and Pop" coin dealers in Idaho that used the A-Mark margin program were true commercial users which are able to fend for themselves without the protections afforded by the CEA.

The analysis and conclusions of Transnor are not only very helpful to us in the A-Mark case, but very useful from an enforcement perspective. Judge Conner's opinion on the definition of a futures contract is well-reasoned and soundly grounded in both federal and CFTC caselaw. We fear an overly-broad interpretation of Transnor may not only have serious implications for our own case, but could legitimize the practices engaged in by A-Mark. We urge the Commission to be very cautious in this area.

We are asking that any interpretation issued by the Commission incorporate the following concepts:

(1) The exclusion should only apply in situations where a commercial party is purchasing for its own use or inventory. The exclusion should not apply where a commercial buyer is purchasing on behalf of its customers, i.e., where the contracts are offered or sold directly or indirectly to the public. If commercial entities are permitted to act on behalf of their own customers, they in essence function as the exchange without meeting the registration or regulatory requirements of the CEA, and individual investors are not afforded the protections Congress intended they have.

(2) The exception should be limited specifically to the Brent contracts.

We understand that Brent trading involves numerous considerations aside from the futures contract/forward contract issue.

We hope, however, that the Commission will be mindful of the critical role both it and other agencies play in maintaining the integrity of the markets for small and large investors. Perhaps a lesson can be learned from the now infamous #85-2 release that a narrowly drawn interpretation is less likely to create serious gaps in the enforcement structure. We believe a narrow exception for Brent contracts can be constructed without opening the door to allow every commodity contract entered into between commercial parties to fall within the forward contract exclusion.

We understand that the Commission is under a fairly tight time frame on this issue. We, however, are concerned about the collateral impact of the decision being contemplated. I will be in Washington, D. C. on June 18 and 19 and would be pleased to meet with you or your staff to provide further information. If CFTC action is expected before that time, I would be willing to come to Washington the week of June 11.

Please contact me if we can be of any assistance during this process. We view this as a critical area and are anxious to see a proper end result.

Sincerely,

Wayne Klein (drc)

WAYNE KLEIN
Bureau Chief, Securities Bureau
Department of Finance

WK/MTS/drc

cc: Commissioner Fowler C. West
Commissioner William P. Albrecht
Commissioner Robert R. Davis
Commissioner Kalo A. Hineman
Lee Polson, NASAA

H.R. 2374
Written Statement of Kenneth M. Raisler
On Behalf of the Energy Group to the
Subcommittee on Environment, Credit and Rural Development
Committee on Agriculture
U.S. House of Representatives
June 30, 1993

On behalf of the entities listed in the attached Appendix (collectively, the "Energy Group"), I am pleased to submit this testimony on H.R. 2374, a bill to amend the Commodity Exchange Act to require the continued application of the Act's anti-fraud and anti-manipulation provisions. Each of the members of the Energy Group is a producer, processor and/or merchandiser of crude oil, condensates, natural gas, natural gas liquids or their derivatives, or is otherwise engaged in a commercial business related to such commodities. The Energy Group comprises integrated oil and gas companies as well as refiners and suppliers of such commodities, and each of the members of the Energy Group is an active participant in the principal domestic and international markets for crude oil and/or natural gas and the products and by-products thereof.

As the applicants for the Commodity Futures Trading Commission's Exemption for Certain Contracts Involving Energy Products, 50 Fed. Reg. 21286 (April 20, 1993), the Energy Group wants to make it clear that we are adamantly opposed to any form of fraud in our markets. Our view, however, is that the bill before the Subcommittee, which removes the CFTC's discretion to grant an exemption from the Commodity Exchange Act's (the "Act") anti-fraud and anti-manipulation provisions, is not an effective way to address the issue. We appreciate the Subcommittee Chairman's invitation to receive our views and hope that this testimony may clarify some of the misperceptions about the energy markets, the scope of the CFTC's Exemptive Order and its decision not to apply its anti-fraud jurisdiction. In our view, the CFTC should retain the discretion granted in the Futures Trading Practices Act of 1992 (the "FTPA") in order to provide legal certainty and stability in appropriate markets.

The CFTC's authority to grant exemptive relief is provided in Section 502 of the FTPA, which added a new Section 4(c) to the Act and granted the Commission the authority to exempt "any agreement, contract, or transaction (or class thereof)" from the off-exchange trading prohibition imposed under Section 4(a) of the Act and from any other provisions of the Act. The provision "is designed to give the Commission broad flexibility in addressing these products either generically or on an individualized, case-by-case basis." H.R. 978, 102d Cong., 2d Sess. p. 81 (1992) (the "1992 Conference Report"). The 1992 Conference Report makes the further point that, "[t]he goal of providing the Commission with broad exemptive powers . . . is to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner." At no time in the lengthy debate on CFTC Reauthorization was it ever suggested that the CFTC's exemptive authority should be limited (other than with respect to securities derivatives) or that the CFTC should not have authority to exempt transactions from its anti-fraud and anti-manipulation jurisdiction. For the reasons set forth in this testimony, we see no basis to upset the careful work of Congress in the FTPA so recently enacted. To limit the CFTC's discretion, as suggested in H.R. 2374, could serve to undermine the legal certainty and stability that Congress sought to achieve in granting the CFTC broad exemptive powers.

Our testimony addresses the retroactive application of H.R. 2374 to the CFTC's Exemptive Order for Energy Contracts. This is the only situation to which the bill would apply and, to our knowledge, is the only situation where it is currently contemplated to apply. Thus, while there may be other special situations where the CFTC may elect to exempt contracts from the anti-fraud or anti-manipulation provisions of the Act, our testimony only addresses the bill as it applies to Energy Contracts.

The FTPA

The Act generally prohibits the trading of futures contracts in the United States other than on a designated "contract market", and futures contracts traded off-exchange might therefore be found to be in violation of the Act. Act, § 4(a). Pursuant to Section 2(a)(1) of the Act, however, this prohibition does not apply to "any sale of any cash commodity for deferred shipment or delivery", commonly known as a "forward contract". In reliance on the forward contract exclusion, commercial entities have, throughout the history of the Act and its predecessor statutes, routinely entered into a variety of off-exchange transactions in connection with their regular business activities with the understanding that such transactions were outside the scope of the Act and Commission regulations.

As Congress noted in the 1992 Conference Report, however, a District Court in 1990 found that certain contracts for the forward purchase and sale of Brent blend crude oil, referred to as "15-day Brent contracts", were futures contracts. 1992 Conference Report at 82, citing, Transnor (Bermuda) Limited v. BP North America Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1990) ("Transnor"). That decision, the first such decision in the history of the Act which found that contracts entered into solely between commercial entities could be construed to be futures contracts, created substantial confusion and uncertainty regarding the legal status of a wide variety of legitimate and longstanding commercial practices in the energy markets. As a result of the Transnor decision, many participants in the Brent market and other commercial energy markets either ceased their trading activities completely or restricted their activities to areas outside the United States. Those U.S. participants in the Brent market which were unable to trade from locations outside of the United States found, in many instances, that non-U.S. counterparties simply refused to deal with them. The result was a reduction in the level of 15-day Brent transactions, along with a reduction in trading in other oil markets, and a significant impairment of hedging and other commercial opportunities for energy market participants. This in turn adversely affected energy users and consumers.

In response to the adverse effects of the Transnor decision, and in an effort to clarify that 15-day Brent transactions and other similar agreements are outside the Act and Commission jurisdiction, the Commission issued a statutory interpretation in September 1990. Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39188 (Sept. 25, 1990) (the "Statutory Interpretation"). The Statutory Interpretation represented an important and essential step in resolving the uncertainties generated by the Transnor decision, and the Energy Group strongly supports its continued validity. While the Statutory Interpretation gave comfort to many market participants, uncertainty remained, particularly among foreign-based oil companies who refused to enter into transactions with U.S.-based counterparties because of their concern about the application of Commission jurisdiction.

In the course of its deliberations on the FTPA, the Congressional conferees acknowledged the effect of the Transnor decision and the uncertainty that remained after the Commission's issuance of the Statutory Interpretation in response to that decision. 1992 Conference Report, at 82. Congress noted that "[m]any markets of this nature are international in scope; foreign parties are already engaging in such transactions free of restraints imposed by the Act that may create competitive disadvantages for U.S. participants". Id. In granting the Commission exemptive authority by the adding of a new

Section 4(c) of the Act, Congress stated that it "expect[s] and strongly encourage[s] the Commission to use its new exemptive powers promptly upon enactment of this legislation in four areas where significant concerns of legal uncertainty have arisen: (1) hybrids, (2) swaps, (3) forwards, and (4) bank deposits and accounts." Id. at 81 (emphasis added). Thus, having been given broad exemptive authority, Congress expected and strongly encouraged prompt Commission action to address transactions which might not have been sufficiently clarified by the Statutory Interpretation.

CFTC Energy Exemption

On November 16, 1992, the Energy Group submitted its application for exemptive relief for certain contracts for the deferred purchase and sale of energy-related commodities. The application took into account the different interests that are addressed by CFTC anti-manipulation and anti-fraud jurisdiction. Recognizing the CFTC's historic and continuing interest in protecting against manipulation in both the futures and the related cash markets, the application proposed that the CFTC's anti-manipulation jurisdiction not be restricted with respect to energy transactions. Because the CFTC had never overseen energy physical market participants who, as substantial commercial parties, could protect themselves, the application did not request that the CFTC apply its anti-fraud jurisdiction. In both respects, the application was consistent with the Statutory Interpretation.

On January 27, 1993, after the publication of the Commission's final rules exempting swaps and hybrid instruments (which included bank deposits and accounts), the Commission's proposed Order exempting certain contracts involving energy products was published. 58 Fed. Reg. 6250. The proposed Order was limited to "commercial participants who, in connection with their business activities, incur risks related to the underlying physical commodities, have the capacity to make or take delivery under the terms of the contracts, and are also eligible 'appropriate persons'" as defined in the proposed Order (including entities with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000). The proposed Order was limited to "bilateral contracts between two parties acting as principals" which "[i]mpose[d] binding obligations on the parties to make and receive delivery of the underlying commodity or commodities, with no right of either party to effect a cash settlement of their obligations without the consent of the other party". Specified contracts which provide for settlement of the obligations in a manner other than by physical delivery were permitted in the proposed Order. The Order proposed to apply the CFTC's anti-manipulation jurisdiction but not its anti-fraud jurisdiction. In addition to issuing the proposed Order, the Commission's Federal Register notice identified particular issues for comment. These included the question whether "Energy Contracts as described in the release [should] be exempt from section 4b of the Act [the anti-fraud provision]".

Sixteen comments were received by the Commission including eight from active participants in the energy cash or forward markets or entities representing such participants, three from futures exchanges, three from futures industry associations, one from a bar association committee and one from an attorney. All but one of the commenters generally supported issuance by the Commission of the proposed Order. No commenter explicitly supported the application by the Commission of anti-fraud jurisdiction. To the contrary, almost all of the commenters opposed applying this authority. The commenters were of the general view that given the commercial characteristics of these transactions and the significant requirements to participate, section 4b of the Act (anti-fraud) should not be applied to Energy Contracts. Commenters observed that since such transactions generally are recognized to be forwards excluded from the Act and the Commission's jurisdiction, participants have not had any expectation of protection afforded by the Act or the CFTC.

Instead, they have relied on existing statutory and common law prohibitions; imposing an additional standard of liability would be duplicative and unwarranted.

At a public meeting on April 13, 1993, the Commission adopted its Final Order providing for an Exemption for Certain Contracts Involving Energy Products (the "Exemptive Order"). The exemption was adopted by a 2-1 vote, the concern of the dissenting Commissioner being that the Commission should apply its anti-fraud jurisdiction. The Exemptive Order closely followed the terms of the proposed Order and did retain anti-manipulation jurisdiction. The exemption covers contracts for the purchase and sale of crude oil, condensates, natural gas, natural gas liquids, and products derived from such commodities which are used primarily as an energy source. Contracts must be bought and sold by commercial participants, as defined in the Order, be bilateral contracts between two parties acting as principals, and impose binding obligations on the parties to make and receive delivery without a right of either party to effect a cash settlement without the consent of the other party (subject to the parties' rights to enter into specified contracts for settlement of their obligations in a manner other than by physical delivery). It is the view of the Energy Group that the exemption provides the legal certainty that Congress directed the Commission to achieve for commercial contracts in the energy markets. The legal certainty that the Commission has provided in its Exemptive Order will avoid potential litigation and allow U.S.-based energy companies to enter into transactions in these markets with foreign-based companies that, without the Order, have refused to trade because of their concern about the application of CFTC jurisdiction.

<u>Anti-Fraud Jurisdiction</u>

We reiterate our strongly held position that there is no place for fraud in the energy markets. Our view, however, is that H.R. 2374, by directing the CFTC automatically to apply anti-fraud jurisdiction, will not achieve its desired results. Instead, it will create false perceptions and confusion that may deter important participation in the markets.

The CFTC's anti-fraud provisions only apply to transactions that the CFTC determines are subject to the Act. The commercial buying and selling of goods, including energy, have long been outside of Commission and generally federal government regulation. The transactions described in the Exemptive Order are generally recognized by the CFTC and others to be forward contracts outside of the CFTC's jurisdiction. The CFTC's Order does not seek to expand the types of transactions or range of participants currently in the physical energy markets. Instead, the exemption only seeks to provide legal certainty that these activities which have been ongoing without CFTC oversight or involvement are clearly outside of the CFTC's jurisdiction. While there is no evidence of fraud in the traditional physical energy markets covered by the Exemptive Order, if fraud were to occur, CFTC jurisdiction would almost certainly be ineffective. The CFTC does not have the staff or the expertise to police the physical energy markets and retaining anti-fraud jurisdiction could create the misleading impression that it is able to do so. Rather than expecting the CFTC, with its limited jurisdiction and resources, to oversee these markets and protect against fraud, participants and authorities should seek recourse under other clearly applicable state and federal statutes, including those providing for criminal sanctions.* In addition,

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* Indeed, the Final Order is fully consistent with the recommendation of this Committee, which was adopted into law in the Futures Trading Act of 1982, to amend the definition of "commodity trading advisor" to eliminate potential Commission jurisdiction (including anti-fraud jurisdiction) over persons who advise with respect to cash commodities or their value, including advice to individual members of the general public regardless of net worth. Futures Trading Act of 1982, Sec. 201; H.R. Report No. 97-565, 97th Cong., 2d Sess. 130 (1982).

counterparties, of course, can rely on an existing body of commercial contract laws and state and common law fraud statutes as the basis to litigate their disputes.

It is important to recognize that the Exemptive Order does not permit activities that could be the cause of public fraud. For example, boilerrooms, generally recognized as enterprises that use high-pressure sales tactics to solicit the general public, clearly are not eligible for an exemption under the terms of the CFTC's Order. The general public and, indeed, individuals are not eligible for the exemption. Both parties to each energy transaction must be commercial participants who have substantial net worth or assets ($1 million/$5 million) to be eligible. Moreover, entities "formed solely for the specific purpose" of taking advantage of the exemption are not eligible. Therefore, otherwise ineligible parties cannot circumvent the exemption by creating a separate trading vehicle. Public "marketing" and "sales", whether high-pressure or not, also are clearly outside the intended scope of the Exemptive Order. Because a boilerroom marketing energy products would not qualify for the exemption under the specific terms of the Exemptive Order, the CFTC would have available its full array of enforcement authority, including its anti-fraud authority.

Furthermore, the CFTC's anti-fraud statute covers fraud committed by one person acting "for or on behalf of" another. It is designed to address activity by a person, such as a broker, who is generally in a stronger bargaining position than its customer, and incurs specified legal duties to the customer as a result of their relative positions. There are no "customers" that can be eligible for the Exemptive Order. The Exemptive Order only applies to "bilateral contracts between two parties acting as principals," each commercials with a connection to the energy business. In essence, the CFTC's fraud provision has no application to transactions eligible for the Exemptive Order. To imply otherwise expands the scope of the Exemptive Order to exempt transactions that should be governed by all of the provisions of the Act.

Congress directed the CFTC to use its exemptive authority to address legal uncertainty in the "forwards" area. It is important to keep in mind that transactions covered by the Exemptive Order are or closely resemble "forward" contracts which have never been subject to CFTC anti-fraud jurisdiction or any other provisions of the Act. The narrowly-drawn Exemptive Order for Energy Contracts, as issued, without the application of the CFTC's anti-fraud jurisdiction provides needed legal certainty. In so doing, it avoids competitive disadvantage for U.S. participants whose foreign counterparts, no longer confused about the applicability of the Act, will not be reluctant to enter into Energy Contracts in the U.S. This result provides important benefits to U.S. energy companies (and energy consumers) by promoting greater certainty in the sourcing of supply and pricing of purchases and sales of crude oil, natural gas and products.

Conclusion

For the reasons stated, we cannot endorse H.R. 2374 insofar as it would require the application of the anti-fraud provisions of the Act to all exemptions the CFTC may issue. We endorse the goal of Congress in the FTPA to give the CFTC "broad exemptive powers" to "create legal certainty" and "stability" for markets such as the energy markets. There is no evidence that the CFTC has or will abuse its powers. The advantage of the FTPA structure, as illustrated by the three exemptions that the Commission has issued to date (swaps, hybrids and forwards), is that the CFTC can tailor each exemption to the particular market. To the extent that there are unintended effects of the Exemptive Order for energy products, which we see no basis to occur, the CFTC can always revisit it to tighten the restrictions on who can participate in these markets or to clarify the terms of exempt transactions. To rigidly apply the Act's anti-fraud provisions serves to undermine the goals of legal certainty and stability without achieving any other public benefits. I appreciate the opportunity to present this testimony. Should the Committee have any questions, I will be pleased to respond on behalf of the Energy Group.

(Attachment follows:)

Appendix A

BP Oil Company

Coastal Corporation

Conoco Inc.

Enron Gas Services Corp.

J. Aron & Company

Koch Industries Inc.

Mobil Sales and Supply Corporation

Phibro Energy Division of Solomon Inc.

Phillips Petroleum Company

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June 30, 1993

Honorable Glenn English,
Chairman,
Subcommittee on Environment,
Credit and Rural Development,
Committee on Agriculture
U.S. House of Representatives
Room 1301, Longworth House Office Building
Washington, D.C. 20515

Dear Congressman English:

We appreciate the opportunity to comment on H.R.2374, which is being considered by your subcommittee. As you know, the International Swaps and Derivatives Association (formerly the International Swap Dealers Association) is an international association that represents over 150 firms that participate in swaps and other derivative transactions.

The purpose of this letter is to express several reservations and concerns that we have regarding H.R.2374. First, the Futures Trading Practices Act of 1992 (the "FTPA") sought to promote legal certainty by vesting the Commodity Futures Trading Commission (the "CFTC") with broad exemptive authority. By providing the CFTC with this authority, Congress permitted the CFTC to fashion the terms of an exemption without necessarily having to resolve often difficult questions concerning the jurisdictional scope of the Commodity Exchange Act (the "CEA"). H.R.2374 would cut back on this broad authority less than seven months after it was enacted. We believe that this would undermine an important goal of the FTPA. As the Conference Report states, "[i]n granting exemptive authority to the [CFTC] . . ., the Conferees recognize the need to create legal certainty for a number of existing categories of instruments which trade today outside of the forum of a designated contract market (H.R. Rep. No. 978, 102d Cong., 2d Sess. (1972) at 80).

Second, we believe that it is appropriate for the CFTC to retain the power, which Congress granted to it in the FTPA, to determine, on a case by case basis, whether to grant exemptions from the anti-fraud and anti-manipulation provisions of the CEA. The Bill by its terms contemplates that the CFTC may grant exemptions from these provisions in cases where Federal banking and securities laws apply. We believe that the CFTC should maintain the authority which it now has to grant such exemptions in other circumstances it deems appropriate as well. Under the FTPA, the exemptions may only be granted where the CFTC concludes that it is consistent with the public interest to do so. This includes any exemption from exercising anti-fraud or anti-manipulation authority over particular transactions or persons. We believe that the public interest test will ensure that the CFTC's exemptive authority will be used judiciously.

Third, we believe that the enactment of H.R.2374 could create confusion as to its applicability to certain exemptions already granted by the CFTC. In particular, it is not clear whether the Bill would require a change in the exemption for swap agreements that is contained in Section 35.2 of the CFTC's regulations (17 C.F.R. § 35.2). That exemption expressly provides that certain specific anti-fraud and anti-manipulation provisions will remain applicable to swap agreements that, absent the exemption, would otherwise be subject to CEA jurisdiction. The confusion arises because H.R.2374 refers only to "anti-fraud" and "anti-manipulation" provisions of the CEA; it does not specify whether the sections enumerated in the swap exemption are the ones contemplated by H.R.2374.

Fourth, we believe that any amendment to the CEA that would alter the regulatory structure that applies to swap agreements, hybrid securities and other off-exchange transactions should await completion of the studies now being conducted by the General Accounting Office, the CFTC, the Securities and Exchange Commission and the Group of

Thirty concerning these transactions. As the Subcommittee is aware, the Conference Report on the FTPA specifically contemplated that these studies be undertaken in order to determine if there is a need for additional legislation.

Fifth, we note that H.R.2374 would require the CFTC to implement its provisions through the issuance of interim final regulations. Such a process would eliminate the opportunity for prior notice and public comment. We believe it would be more appropriate to require advance notice and an opportunity for public comment. Among other things, we believe that the CFTC should have the benefit of public comment before determining how the anti-fraud or anti-manipulation provisions of the CEA will apply in the context of a particular rulemaking.

We will be pleased to respond to any additional questions that the Subcommittee may have.

Sincerely,

Joseph Bauman,
Chairman,
International Swaps and
Derivatives Association

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Donna Redel
Chairman

June 28, 1993

The Honorable Glenn English
Chairman
Subcommittee on Environment, Credit,
and Rural Development
Committee on Agriculture
U. S. House of Representatives
Washington, DC 20515-6001

Dear Mr. Chairman:

Commodity Exchange, Inc. (Comex) was pleased to learn of the June 30 hearing and markup before your Sucommittee on H.R. 2374, a bill to amend the Commodity Exchange Act to ensure continued application of the Act's anti- fraud and anti-manipulation protections. Due to scheduling conflicts I will be unable to testify at the hearing; however, I would like to express Comex's views on the pending bill.

H.R. 2374 would prohibit the CFTC from granting exemptions from the Commodity Exchange Act's anti-fraud and anti-manipulation provisions unless the exempted transactions or persons would be subject to comparable anti-fraud protection under the Federal securities and banking laws, as determined by the Commission. Comex supports the bill and your continued efforts to ensure the integrity of U.S. futures markets.

Comex firmly believes the American public is best served by markets where prices are reached openly and available for all to see. As the Commission uses its exemptive authority it should seek, to the maximum extent practicable, to ensure comparable treatment to exchange- and off-exchange-traded exempted transactions and individuals. This approach, rather than protecting the exchange or off-exchange markets from competing with each other, is preferable. The Commission should be mindful that granting an exemption to an off-exchange product without a similar grant to its exchange-traded counterpart would likely favor, in effect, the off-exchange over the exchange-traded product. Also, failure to provide comparable treatment could potentially hamper the ability of the affected exchange market to serve its hedging and price discovery functions.

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We are unaware of any analyses concluding that retention of anti- fraud and anti-manipulation authority by the Commission will adversely affect the market for otherwise exempted transactions. Retention of these authorities for otherwise exempted transactions and persons can serve as a basis for relief for participants in transactions found to be fraudulent or manipulative.

Thank you again for this opportunity to express our views on H.R. 2374. If I or anyone on the Comex staff can be of assistance as this bill continues through the legislative process, please do not hesitate to call on us.

Sincerely,

Donna Redel

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