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CFTC REGULATION AND OVERSIGHT OF DERIVATIVES

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

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CFTC REGULATION AND OVERSIGHT OF DERIVATIVES

WEDNESDAY, JULY 10, 2002

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD–106, Dirksen Senate Office Building, Hon. Tom Harkin, [Chairman of the Committee], presiding.

Present or submitting a statement: Senators Harkin, Lincoln, Miller, Nelson, Lugar, Fitzgerald, and Crapo.

The CHAIRMAN. Good morning. The Senate Committee on Agriculture, Nutrition, and Forestry will come to order.

This morning, I am pleased to welcome everyone to our committee for a hearing on regulation of markets in over-the-counter derivatives and the CFTC's oversight role. The main focus of this hearing will be the regulatory treatment of derivatives, based on "exempt commodities," such as energy and metals, following the passage of the Commodity Futures Modernization Act of 2000. During this hearing, the committee intends to examine the scope of the CFTC's authority and its exercise of its authority to ensure market transparency, to prevent and punish fraud and manipulation, and to restore confidence in these markets.

The impact of OTC derivatives markets reaches well beyond the immediate parties to the transactions. The integrity of these markets and the confidence in them are critically important to shareholders, investors, consumers, and the broader economy.

The OTC derivatives markets have assumed an increasingly large role in the U.S. economy. A recent conservative estimate put the size of the global OTC derivatives markets at $111 trillion. The U.S. share of that market is estimated to be at least two-thirds. Derivatives based on exempt commodities, such as energy and metals, make up a very small percentage, probably no more than 2 percent of the total OTC derivatives market. However, derivatives play an increasingly important role in energy and metals markets, which are, in turn, critical to our overall economy.

When the CFMA was enacted in December of 2000, one of its primary goals was to ensure the legal certainty for OTC derivatives. For the most part, the CFMA was based on the recommendations of the President's Working Group on Financial Markets issued in 1999. The President's Working Group recommended that certain transactions involving financial derivatives be excluded from the CFTC's jurisdiction. The President's Working Group did not rec-

ommend a similar exclusion for transactions involving energy and metals derivatives.

During development of legislation in the Senate, there was discussion of the issue of oversight of energy and metals derivatives markets. Senator Lugar and I both supported in this committee a version of the legislation that was consistent with the recommendations of the President's Working Group and excluded only financial derivatives, not energy and metals derivatives, from the CFTC's jurisdiction. The bill codified an exemption with specific safeguards for certain commodities, such as energy and metals.

The final version of the legislation included in the omnibus appropriations bill differed from our committee bill regarding energy and metals derivatives markets. I supported the CFMA, although I had some concerns about its treatment of energy and metals products. There is a statement I gave on the floor to which I would refer you that is in the Congressional Record regarding that, because I thought at the time it had a number of very positive features. On the whole, I thought it was a good bill, and I still think it is. It is important that we do not undermine the legal certainty that the legislation brought to the CFTC derivatives market. However, if there are unaddressed problems with some types of derivatives that could give a black eye to all OTC derivatives, then we are going to have to take a look at that.

Although the CFTC is currently investigating allegations of fraud and manipulation in the Western energy markets, some have suggested that the CFTC does not, because of the passage of the CFMA, have sufficient authority to effectively and successfully investigate and punish fraud and manipulation in derivatives markets for exempt commodities, again, energy and metals. Questions have also been raised about the CFTC's ability to prevent fraud and manipulation in the first place.

Today's hearing will focus on these issues and I hope it will help answer some of these questions. We hope also to discuss possible legislative solutions to any problems identified in the existing regulatory framework for OTC derivatives based on exempt commodities.

Our first witness, of course, Senator Feinstein, has proposed legislation to increase transparency in the energy and metals derivatives markets and to clarify and strengthen the CFTC's authority to investigate and punish fraud and manipulation in those markets.

In addition to the distinguished Senator from California, we have two panels of witnesses here with us today. The first panel consists, of course, of chairman Newsome and commissioner Erickson of the CFTC, and we are pleased that they could be with us today.

Our second panel consists of witnesses Randall Dodd, Director of the Derivatives Study Center; John Coffee, Professor of Law at Columbia; Neal Wolkoff, the Executive Vice President and COO of the New York Mercantile Exchange; Mr. Patrikis representing the International Swaps and Derivatives Association; and Richard Green, Chairman of Aquila, Incorporated, an energy trading company. We welcome all the witnesses to the committee and look forward to our hearing.

With that, now I would turn to our distinguished ranking member, Senator Lugar, who provided such great leadership and I was pleased to work with him very closely in working out the CFMA that was passed in the year 2000, which as I just stated in my opening statement, I still think is a good bill and has a lot of good things in it. Perhaps now we have to look at some of the other things that are exempt and that is what the purpose of this hearing is. Senator Lugar was one of the driving forces in the Modernization Act and I turn now to him for his statement.

[The prepared statement of Sen. Harkin can be found in the appendix on page 66.]

Senator LUGAR. I thank you very much, Mr. Chairman. I just ask that my statement be placed in the record in full.

The CHAIRMAN. Without objection.

Senator LUGAR. I would just make the comment that I think your recitation of the history of the Commodities Futures Act is accurate and certainly reflects the gravity of the situation our committee faced. We met regularly, and, in fact, a number of the hearings were in this room, with Alan Greenspan, the Secretary of the Treasury, and other people who felt after the long-term capital management failure that the financial institutions of this country could be jeopardized and that at least the laws that were on the books might contribute to that jeopardy.

We took that seriously and proceeded really for the better part of a year and a half, as you will recall, through seminars that involved many people in all facets of the futures industries, as well as experts from academia and governmental responsibility, and in the final stages of that Congress, the Act finally came from conference in the manner you suggested.

It is fully appropriate that this committee have an oversight of how that has worked. We have been busy in other things, including a comprehensive farm bill, and it is appropriate we return now to some of our previous work. I welcome the hearing. I am delighted that our colleague, Senator Feinstein, leads off this morning because she has given a great deal of thought and leadership in this area. I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Lugar, and again, I thank you for your great leadership in this area.

The CHAIRMAN. Now, we welcome our distinguished fellow Senator from the State of California who has again taken up this issue with great force and great intellect and has painted for the public the picture of what has happened in California and why we need to revisit this issue of whether or not they should be exempt or not.

I thank Senator Feinstein for being here. Your statement will be made a part of the record in its entirety, and please proceed as you so desire, Senator Feinstein.

STATEMENT OF HON. DIANNE FEINSTEIN, A U.S. SENATOR FROM CALIFORNIA

Senator FEINSTEIN. Thank you very much, Mr. Chairman, and thank you very much, Senator Lugar, Senator Miller, for being here. Mr. Chairman, I particularly appreciate your keeping your word. I have been pestering you for this hearing for a while and

I thank you very much for holding it, and I want to thank both of you for your work.

Mr. Chairman, you accurately quoted the record, and I appreciate that very much. This committee did include CFTC oversight over energy derivatives when the bill came out. The Senate bill did. As you know, in conference, that was changed.

Mr. Chairman, last night, I was listening to some former CEOs on television rather critical of the Congress for not taking steps to really close loopholes and exert the kind of legislation that would produce the kind of regulatory oversight over the markets. This is one of those loopholes that happened in 2000 and I want to thank you for holding this hearing on this legislation which would restore oversight, transparency, and reporting to energy trading markets and ensure that the CFTC has full anti-fraud and anti-manipulation authority, including the authority to investigate wash trades.

This bill closes the loophole that you refer to. That loophole created a kind of niche market so that derivatives traded online could be traded without any anti-fraud, anti-manipulation oversight, without transparency, without net capital requirements, with no records and no audit trail. This was wrong, in my view, Mr. Chairman.

Let me speak for a moment about what we have learned about the energy sector in the past couple of months and the operations of some of the energy companies. First, CMS Energy admitted that 80 percent of its trades were round-trip or wash trades and were made simply to increase volume. That is 80 percent.

Reliant admitted to $6.4 billion in wash trades from 1999 to 2001, which the company characterized as energy swaps.

Three, Duke confessed to $1.1 billion in wash trades and stated that $650 million of these trades were executed on the Intercontinental Exchange, an electronic trading facility exempt from CFTC oversight because of the Commodities Futures Modernization Act.

As I understand how the Intercontinental Exchange works, not only does this exchange have no responsibility for trades or wash trades executed on its exchange, it does not take any responsibility for checking that a transaction has, in fact, even been executed. Thus, a company could manipulate prices or game the market without even executing a single trade.

Now, what is a wash trade? A company sells to another who sells back at the same price at the same time. The result boosts revenue without any trade actually having taken place. In my view, it is flim-flam and it artificially inflates revenues and creates an illusion of activity to raise stock prices, and that is what has been going on and it goes on in secret. There is no audit trail. There is no record kept. There is no anti-fraud, anti-manipulation oversight.

In the past year, 12 of the largest energy companies in the United States have lost about $188 billion of capital. That is 71 percent of their market value. The credit ratings of several of those energy companies have been severely downgraded. Some are at junk bond or near junk bond status today.

In the past month, Dynegy and Aquila have both halted their energy trading operations. I understand that Williams is on the verge of doing the same thing. Yet many of these energy companies continue to fight transparency, record keeping, and Federal oversight,

the very components that are vital for markets to work and for investors to be confident of an upright and fair system.

I want to briefly explain my interest in all of this. In May 2000, a severe energy crisis began in California. Electricity that had typically sold for $30 a megawatt hour all of a sudden started to sell for ten times that. This led to the bankruptcy of California's largest investor-owned utility and the near-bankruptcy of California's second-largest investor-owned utility. It also resulted in overcharges of billions of dollars to California rate payers and taxpayers.

In November, California encountered a natural gas crisis. Natural gas is the main cost component of electricity. At one point, what came to my attention was that natural gas was selling at $12 a decatherm in San Juan, New Mexico, and $59 a decatherm in Southern California. Now, transportation cost to move that gas is only a dollar and yet that gas solo for $59. What was happening?

Just about the time Congress passed the Commodities Futures Modernization Act exempting electronic energy trading exchanges from oversight, the crisis began spreading to other Western States. For more than 6 months, Oregon, Washington, and the other Western States experienced the same price spikes as California. The entire crisis lasted for more than a year while energy companies like Reliant, Enron, Duke, Williams, AES enjoyed record revenues and profits.

Obviously, we are all a bit wiser today about energy's markets and the wash trades, in particular. Wash trades, or round-trip trades, involve two or more companies plotting together to execute offsetting trades. I cannot think, really, of a legitimate reason for doing a wash trade, but wash trades can significantly enhance revenues, as I have pointed out, if they are done on an exchange like the Intercontinental Exchange and they can certainly influence price. In my book, this is outright fraud, and these trades would be illegal if they were done on the NYMEX, the Chicago Mercantile, or the Pacific Exchange, and those exchanges would have the responsibility to report it.

However, there is no such reporting or enforcement requirement on electronic exchanges because of, as I have said before, the CFMA created a big loophole. This legislation would ensure that wash trades are subject to full CFTC oversight no matter where they are done, by telephone or by electronic exchange.

Of course, there is Enron, which controlled a large share of the energy market while they engaged in activities that were downright illegal. Many of these activities could have been prevented or at least stopped if regulators had simply had the proper authority and the will.

Now, as I understand it, if I were to trade, let us say, natural gas to you, Senator Harkin, and deliver it to you, that trade is covered by the Federal Energy Regulatory Commission. A record is kept and the Commission has jurisdiction. If I sell it to you and you sell it to Senator Lugar, who sells it to Senator Miller, who sells it to any other entity, none of those interim trades are covered. Or if you sell it back and forth, they are not covered, and there is no record kept, there is no transparency, there is no anti-fraud and anti-manipulation oversight. That is the loophole, and I

believe companies stepped into this loophole and utilized this loophole to game the market.

What I am asking here today, and I am joined with Senator Fitzgerald, Senator Corzine, Senator Durbin, Senator Wyden, Senator Boxer in asking you to please close this loophole.

I am very pleased, and I would like to commend Aquila. Aquila came in, talked to us about the legislation, recommended a couple of changes. We did our due diligence on those changes and we made those changes, and my understanding is that Aquila is going to testify later this morning in support of this legislation.

All I can say is that the time really has come. We have seen the game. We have seen the manipulation of the market. We see the absence of transparency. The time has come to close this loophole. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Feinstein, thank you very much for a very erudite statement, very clear, very concise, and that really drives home what we should be looking at here.

The CHAIRMAN. As you know as well as I do, trying to translate this into terms that the average person understands and how it affects the average person is very difficult. I mean, you are talking about OTC derivatives and derivatives markets and all of a sudden eyes glaze over. How does that affect me? I just want to pay my gas bill and get my gas and that is it, or my electric bill.

We need to be able to tell the average consumer out there in California, in Iowa, in Indiana, how this affects them, how it really affects the markets, how it affects their bottom line and how it affects a lot of the investors in these companies. That is a real challenge we have to do. It is difficult, but we will try our best.

Senator FEINSTEIN. Mr. Chairman, may I say just one thing——

The CHAIRMAN. Sure.

Senator FEINSTEIN [continuing]. Because it is important that the committee know. There was concern that this amendment might cover financial derivatives. We have done our due diligence and we have redrafted it earlier to see that it does not cover financial derivatives. It strictly covers energy and metals. It does cover swaps, wash trades, as you know.

The CHAIRMAN. Sure.

Senator FEINSTEIN. You are absolutely right, and, of course, the way this affects the individual is that it prevents the kind of oversight that can see that the market is functioning in a straight-up, straightforward way, so it allows gaming. Now, what does that gaming do? That gaming raises prices for consumers, and if you do not have the net capital in many of these trades, as apparently Enron did not, the house of cards that is built can crumble and you are left with companies that get into very deep financial trouble, and that has happened and that also affects our constituent because it affects the stock and people lose their money when they have invested in publicly controlled companies.

It is very important. I ran into an officer of the Pacific Coast Stock Exchange when I was in California and he was adamant. He did not understand why—if somebody trades over that exchange, there is a record, there is transparency, there is oversight, there is attribution—why we would allow the creation of these niche entities where none of this would exist, and, of course, they were origi-

nally taken advantage of. Now, at least according to a Wall Street Journal article yesterday which says, "Energy Woes Drain Online Power Trading, Brokers Switch Back to Telephones," which we would cover, "Exchange Pits Admit Quick Fizzle of Once Booming Business Niche." It is very important that we do our due diligence and provide that oversight.

The CHAIRMAN. Thank you Senator Feinstein.

Senator FEINSTEIN. Thank you.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. Senator Feinstein, in your bill, and I know you in the draft have given a lot of thought to this, but explain to me why you make a distinction between trading on the platforms of, say, telephones and Internet, involving what are described as less-sophisticated retail customers—these people would be subject to the anti-fraud, anti-manipulation provisions of the CFMA, as opposed to OTC trading of physical commodities, including energy and metals, on bilateral electronic trading facilities, and these would be the sophisticated persons, at least as defined, who would now be subject to anti-fraud, anti-manipulation, but also reporting and record keeping provisions, and that would include the capital margin requirements, daily trade volume, large trader reports, and so forth.

Essentially, my first question is why not apply the same ore rigorous standards to everybody?

Senator FEINSTEIN. What we have tried to do—and I am not averse to doing that, but what we have tried to do is to apply it where the most volume is, and to cover the phone transactions for anti-fraud and anti-manipulation oversight to require that a record be kept, as well as these electronic exchanges.

Senator LUGAR. I understand that, and, of course, the difficulty of all of that record keeping with phone transactions and the so-called less sophisticated involves a great deal more administration, some critics would say a prodigious amount. I do not know. Experts will have to——

Senator FEINSTEIN. That is correct. That is another reason why we left it out.

Senator LUGAR [continuing]. Have to take a look at this. On the other hand, it occurs to me as we are busy trying to close perceived loopholes, the sophisticated might move to the telephone and become unsophisticated. I do not know how precisely things move in this particular area, and so this gave me some concern as I read through, knowing that this has given you a lot of concern, likewise, and others who have been working with you. I wanted to raise it for your consideration and your thoughtfulness today.

Senator FEINSTEIN. Yes. The only way—because you are right. We cover it for anti-fraud and anti-manipulation oversight, and you are right about the paper. The other thing would be just to prohibit anything that is not traded over one of these big exchanges and we have not gone that route.

I certainly am going to watch very carefully. If there are signs of gaming and manipulation, we at a later time may have to do this, and that is just prohibit the use of the phone for these kinds of trades. At this stage, we have tried to do just—in other words, to limit it, to provide for anti-fraud, anti-manipulation, that a

record be kept, et cetera. We also provide that with respect to capital requirements, that the CFTC would set those capital requirements based on risk.

Senator LUGAR. Well, that is helpful, and maybe some other testimony today will be enlightening, too. By raising this early in the hour, others may have some appraisal——

Senator FEINSTEIN. Right.

Senator LUGAR [continuing]. Because this is a critical part of it.

The other question I have is you have pinned down energy and metals. Some will say there are additional commodities out there. They have identified weather and broadband, for example, and asked, while we are at it, why do we not tackle weather and broadband. Maybe there are others in addition to that. Do you have any response to the inclusiveness question?

Senator FEINSTEIN. Yes. We, and it is controversial with some of our colleagues to include metals. I understand that the silver people do not want to be included. However, if you look back into the past, there has been fraud in the metals market and this is why—and I am glad that my co-sponsor, Senator Fitzgerald, has arrived—that is why we included it, because there have been instances of fraud and they were rather large when they took place. I do not quite see, if we are going to cover energy, why we should create a loophole and allow metals out of it.

Senator LUGAR. No, I was not suggesting that. I was suggesting that some would say beyond metals and energy——

Senator FEINSTEIN. In broadband?

Senator LUGAR [continuing]. How about broadband and weather?

Senator FEINSTEIN. We have not had any experience with that to be able to go back and say there was fraud. I am not averse. I believe, and history is going to show this to be correct, that we should not create any loopholes, that what we need to do to provide for investor confidence is to have transparency. Transparency is good. If people can examine a trade or the CFTC or the FERC or the SEC, whatever the appropriate body is, can examine a trade and say, this trade is forthright, it is straight-up, it stands the test of scrutiny, that is fine.

To create an anonymity where all these things can take place without records, without capital requirements, without audit trails, without oversight, is a mistake and I think it creates the opportunity for the hot-shot young trader, bright but perhaps with not the level of ethics that we want, to make a lot of money and to game the system, and I do not want to see us do that and I do not believe stockholders do, either.

Senator LUGAR. I thank you for your testimony. Let me just say that I feel equally outraged, as you do, about the energy trading business. We have to have reform. The purpose of my questions is to see how broad the reform ought to be, and not to rebut the need.

Senator FEINSTEIN. Right. I understand that.

Senator LUGAR. It seems to me there is a glaring problem here that really demands public attention, and so I appreciate the hearing and I thank you for your work.

Senator FEINSTEIN. Thank you very much.

The CHAIRMAN. Thank you, Senator. I know that you have a schedule conflict, Senator Feinstein. I would ask other members if

they would be so kind as to permit Senator Feinstein to leave, if that is all right, and then we can move on to our panel.

Senator FITZGERALD. If I could just thank Senator Feinstein for appearing before our committee. I co-sponsored the legislation with Senator Feinstein when we offered it as an amendment. I am supportive of this legislation as we try to bring forward a full bill.

I would point out that the President's Working Group specifically recommended, unanimously, that the exclusion that is available for financial commodities with infinite supply not be extended to nonfinancial commodities with a finite supply. Somehow, while we tried to craft a bill that met the recommendations of the President's Working Group, somehow, somewhere in the process, somebody slipped in this mysterious exemption for energy and metals trading and they are being treated differently than all other nonfinancial commodities that have a finite supply.

We have to close the loophole and I thank Senator Feinstein and compliment her for her tenacity on this issue. I will be with you every step of the way on this. I was much chagrined that we could not pass that very simple reform on the Senate floor.

Senator FEINSTEIN. I want to thank you, Senator. You have been with me all the way. You were there when we tried to settle problems with Senator Gramm, were not able to do so, and I really appreciate your work on this, as well. Thank you.

Senator FITZGERALD. Thank you.

The CHAIRMAN. Senator Lincoln or Senator Miller.

Senator CRAPO. Mr. Chairman, I just had a question that I was going to ask with regard to what happened back with the CFMA, but I could ask that of the chairman, since you were there at the time, and we could let Senator Feinstein leave.

Senator FEINSTEIN. Thank you. Thank you, Mr. Chairman, and thank you, Mr. Crapo.

The CHAIRMAN. Thank you, Senator Feinstein, very much.

Now we would like to bring to the witness table Mr. James Newsome, the Chairman of the Commodity Futures Trading Commission, and Mr. Tom Erickson, a commissioner of the CFTC.

Senator CRAPO. Mr. Chairman, while they are taking their seats——

The CHAIRMAN. Senator Crapo, yes. You had something you wanted to ask.

Senator CRAPO. Yes. In your opening statement, you indicated that when the Senate was dealing with the CFMA a few years ago, that the bill that the Senate voted on was changed in conference in a specific way that you had concern about. Could you tell me what that—I did not quite understand what that change was that you were describing there.

The CHAIRMAN. What happened was when Mr. Ranier, at that time, had testified—there was a President's Working Group that had made recommendations to this committee under the leadership of Senator Lugar, and perhaps he could best answer that question rather than me because he was chairman at the time, but we agree that we worked very closely on this. When we passed it, we kept the distinction between the financial derivatives—and help me out here, Dick—the financial derivatives and those other derivatives

that covered things that were in limited supply, like energy and metals.

We felt at the time, that because of the—the amount of interest rate trading and things like that in financial markets, that you could make that distinction, and so we left it that way, and that is how it passed the committee. We never got it on the floor and it was wrapped into the omnibus appropriations bill. When it was wrapped in the omnibus appropriations bill all of a sudden, that distinction disappeared. Therefore, the exemption that we had had for the financial derivatives was then applied to the metals and energy derivatives.

We were confronted at that time with a vote on whether to pass the CFMA as a part of the omnibus appropriations bill or to let the whole thing fall. Well, it was part of it. I made a statement on the floor at the time saying that there were a lot of good things in the Act. This committee, under Senator Lugar's guidance, had done great work, I think, in modernizing the Act. I said at the time I did not agree with erasing this distinction between financial derivatives and energy and metals, but in the overall interest of getting the bill passed, we would do it and get it passed, and that is exactly what happened.

Senator CRAPO. Just so I understand, as I understand the bill that passed, it had an exclusion for financial transactions——

The CHAIRMAN. That is right.

Senator CRAPO [continuing]. An exemption for energy and metals and some other transactions——

The CHAIRMAN. Right.

Senator CRAPO [continuing]. Then complete coverage for other, like farm commodities and other types of transactions. It created three categories, and I am just trying to understand whether this change that you are talking about was the establishment of the middle category or whether that exemption category was in the original proposal.

The CHAIRMAN. Say that again.

Senator CRAPO. Interestingly, this Act created, as I understand it, and I was not here when that happened in the Senate, but as I understand it, what happened was it created three categories, basically, excluded transactions, which were totally not covered——

The CHAIRMAN. That is right.

Senator CRAPO [continuing]. Exempted transactions, which were subject to anti-fraud and price manipulation and other protections, and then totally covered transactions, which would be subject to over-the-counter trading requirements and so forth. Were those three categories in what the Senate originally considered or was the situation you are talking about where it was changed something that created one of those three categories?

The CHAIRMAN. Mr. Erickson is going to testify to that, but again, as I understand it, the Senate bill fully and clearly maintained CFTC's anti-fraud and anti-manipulation authority over exempt commodities, such as energy and metals. Now, there seems to be an ambiguity as to their authority to do this and that is really what we are trying to clear up, that ambiguity, and to make sure that they do have that authority.

Senator CRAPO. All right.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. Let me just add one thought, and others may have more, but essentially, the bill that came out of this committee had no exemptions for metals and energy. Somewhere in the conference procedure, and I do not really remember when because we were at the end of the session. This bill had been given up for dead a long while back, that is, the totality of it, despite Alan Greenspan, the Secretary of the Treasury, the President's Working Group, and almost everybody who was worried about the financial condition of the country centered upon this as a salvation.

Somebody in the process of that conference talked about exemption of bilateral trade on electronic platforms, precisely the sort of thing that Enron was to be involved in.

Senator CRAPO. All right. Just so——

Senator LUGAR. We all should have been brighter, perhaps, in reading the type, but nevertheless, that is one that already occurred and that is why it is there.

Senator CRAPO. For the benefit of the chairman and the ranking member and the witnesses, I guess the question I am getting at is it seems to me that complete coverage under the Act requires basically that the transactions be handled on the Chicago and New York Exchanges and a very major change in terms of how they are handled from today. The Act created a middle category that had the protections for transparency and price manipulation and antifraud provisions and so forth but did not require a certain category to be subjected to being traded on the exchanges.

The question I am trying to get at, and I guess maybe the witnesses can help answer this, is whether the original approach of the President's Commission contemplated that everything would be traded on the exchanges except financial transactions, or whether this middle category was initially there and somehow there is now a question as to whether there is complete transparency.

The CHAIRMAN. Mr. Crapo, I think that is the question, and I hope that Mr. Newsome and Mr. Erickson are going to address that in their testimony.

Senator CRAPO. Thank you, Mr. Chairman.

The CHAIRMAN. If not, we will get into it. Thank you very much.

Now we welcome James Newsome, chairman, and Tom Erickson, commissioner. Both of your testimonies will be made a part of the record in their entirety and we welcome you here. Please proceed, Mr. Newsome.

STATEMENTS OF JAMES E. NEWSOME, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. NEWSOME. Thank you very much, Mr. Chairman, Senator Lugar, and members of the committee. I am honored to have the opportunity to testify before you today along with my colleague, commissioner Erickson from the CFTC.

In my written submission, I have provided an update on a number of important issues that the Commission is addressing, issues that I think you are interested in. Certainly, the Commission has been very busy since the passage of CFMA. However, this morning, I will focus directly on energy markets.

The CFTC is an independent Federal regulatory agency whose mission is to oversee the futures and options markets in the United States. We take very seriously our mission to ensure that these platforms provide safe, sound, and transparent markets for risk management and price discovery for a variety of commodities, including agricultural, financial, metals, and energy products.

The energy markets are among the largest and most dynamic in the United States. Hundreds of billions of dollars in energy products, which would include electricity, natural gas, crude oil, and gasoline, are traded each year in the United States, both on exchange and in over-the-counter or the OTC markets.

The CFTC regulates the on-exchange futures and options energy markets, which provide significant risk management and price discovery functions for both the retail and institutional investors. Energy products are primarily traded on the New York Mercantile Exchange, which is CFTC registered and regulated.

There is also significant trading in energy products in the OTC markets. As a general matter, the CFMA provided legal certainty for OTC trading in exempt commodities, such as energy products. In addition, the CFMA promoted the growth of electronic trading systems for these commodities. The level of CFTC jurisdiction regarding the OTC market is tailored to the nature of the participant and the commodity. The OTC markets in energy products are generally restricted to large institutional investors that do not need the same protections as retail investors.

The CFMA provided the CFTC with the ability to investigate and prosecute fraud and manipulation in the exempt commodity markets, with some limited exceptions. Enron Online operated an electronic trading platform which accounted for a sizable percentage of the OTC energy product market. It was not registered with the CFTC.

We are all aware of the tragedies that occurred last fall surrounding the collapse of Enron. There have been numerous stories in the press regarding allegations of manipulations in energy markets. Currently, we are conducting a comprehensive, detailed investigation of allegations raised by the Enron collapse and we will continue such investigative efforts to detect and to deter illegal contact in the markets we oversee.

Albert Einstein once said, if you have 7 days to solve a problem, spend the first 6 days defining it. From the beginning of the discussions on these energy issues, my position has been that we need to find the facts first before proposing a solution. My position has not changed.

As to allegations made earlier this year about Enron's role in certain energy market problems, let me assure you that this matter is my highest priority. We are deep into a comprehensive investigation of both the public allegations and other allegations we have uncovered which may involve violations of the Commodity Exchange Act. During the course of our investigation, the Commission has closely coordinated its efforts with the SEC, the FERC, and the Justice Department so that all relevant information is shared and so that investigations continue to proceed without delay.

If violations of the Commodity Exchange Act are uncovered, we will aggressively prosecute those responsible to the fullest extent of

the law. The markets for commodity futures and options serve an important role in our economy and I am committed to protect their safety and their integrity.

As I have said before, the CFMA, in my opinion, created a proper regulatory balance regarding exempt OTC markets to protect the public interest by providing the CFTC with appropriate authority to require transparency when needed for price discovery, to demand records for viewing, and the ability to prosecute fraud and manipulation, at the same time while creating legal certainty and allowing the flexibility needed for market innovation and growth to occur within our jurisdictional boundaries, and it provided market participants with a choice based upon their business needs.

However, Mr. Chairman, if after or even during our investigation it becomes apparent to me that CFMA changes are needed in order for the CFTC to fulfill its mission, I will immediately relay those needs to the committees of our jurisdiction.

Mr. Chairman, I continue to offer a detailed briefing of our investigation at your convenience, and certainly I look forward to answering any questions that you might have.

The CHAIRMAN. Thank you, Mr. Newsome.

[The prepared statement of Mr. Newsome can be found in the appendix on page 69.]

The CHAIRMAN. Before beginning questions, the chairman will now turn to Mr. Erickson, a commissioner of the Commodity Futures Trading Commission. Mr. Erickson.

STATEMENT OF THOMAS J. ERICKSON, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. ERICKSON. Thank you. Chairman Harkin, Senator Lugar, distinguished members of the committee, thank you for this opportunity to appear before you this morning.

I have been asked to comment on three things: First, the scope of the Commission's existing regulatory authority over OTC derivative markets; second, the need for increased Commission authority to prevent fraud and manipulation; and third, the legislative proposals pending before the Senate that would address any deficiencies.

Passage of the CFMA in December of 2000, as you have indicated, brought sweeping change to the regulation of derivatives in the United States, both on- and off-exchange. Nowhere was the change in law more dramatic than its effect on over-the-counter derivatives, more commonly referred to as swaps.

Many of the CFMA's changes to the Act were based on the recommendations of the President's Working Group on Financial Markets. Although the PWG report recommended that bilateral swap transactions in financial commodities be excluded from the CFTC's jurisdiction, it concluded the same case could not be made for physical commodities. The PWG was unanimous in its agreement that the exclusions should not extend beyond financial products.

The CFMA adopted a variant of the PWG recommendations and created three tiers or categories or commodities. Each category defines the CFTC's regulatory interest in derivative instruments, including swaps. Generally, financial commodities are excluded from

the CFTC's jurisdiction. Agricultural commodities are included. All other commodities, including energy and metals, are exempted from the CFTC's jurisdiction.

What this means in application is not so simple. In part, the complexity stems from the fact that the regulatory framework hangs on the distinction between excluded and exempted. An excluded commodity transaction or market indicates that the Commission has no jurisdictional interest. An exempted commodity transaction or market, meanwhile, means that the Commission retains its jurisdictional interest, but that the law limits its application.

Ostensibly, under the CFMA, the CFTC retains its anti-fraud and anti-manipulation authorities over exempt commodities. However, through other provisions in the law, the vast majority of swap transactions in energy and metals commodities markets become excluded. As a result, they are not subject to the Commission's fraud or manipulation authorities.

Thus, we have a gap in the oversight of the regulation of exempt commodity transactions. On the one hand, the Act expects full prosecution of manipulations in exempt commodities in regulated exchange markets. On the other hand, the regulatory regime turns a blind eye to the manipulation of these very same commodities if effected through over-the-counter derivative transactions. I cannot believe this was the intended effect of the CFMA.

From a practical perspective, the Commission's own experience has yielded some significant results in these areas, results that would be difficult, if not impossible, to replicate under the current law. For example, the Commission in 1998 reached a settlement with Sumitomo Corporation for the manipulation of global copper prices. The Commission found that the manipulation imposed enormous costs on traders, manufacturers, and ultimately consumers of copper. More recently, the Commission settled with Avista Energy, Incorporated, for the manipulation of electricity futures.

I am skeptical the Commission could replicate these cases in today's market environment. As the Avista settlement underscores, commodity markets, cash, futures and options, and over-the-counter swap transactions, are increasingly linked. We now know that wash trades and transactions in unregulated swap markets occur, and in certain cases send price signals that raise manipulation concerns. Thus, if we are serious about detecting and deterring fraud and manipulation, these authorities must apply to all derivative transactions on those commodities.

Derivatives markets bring unquestionable efficiencies to the cash markets. The consequent benefits extend not only to market participants, but also to consumers. Thus, I believe if Congress were to restore to the Commission its fraud and manipulation authorities, it must also provide the Commission with the tools to enforce these authorities.

Derivatives marketplaces, like electronic swap exchanges, should adhere to certain minimal regulatory obligations, among them, transparency, disclosure, and some reporting. Our experience with the futures markets has shown us that measures designed to increase market transparency instill confidence in markets, attract speculative liquidity, and increase market integrity by providing

regulators with the means to monitor for fraud and/or manipulation. I believe application of these principles to derivatives markets more broadly is sound public policy, prudent business practice, and common sense.

Unfortunately, we are presently witnessing some of the best arguments in favor of reinstating these principles into our markets. U.S. energy markets are suffering a crisis in confidence. Six months ago, we could define that crisis by the tens of millions of energy consumers in Western States who believed the markets had been manipulated. Today, none of our Federal regulators has been able to assure them that this was or was not the case, and it is not even clear which regulators should be answering the question.

More recent revelations of wash sales by numerous commercial markets have expanded the scope of this crisis, eroding the trust and confidence firms have in each other. In this environment, liquidity dries up and the market efficiencies created by all derivatives are put at risk. Modest legislation is a good first step toward restoring the lost confidence and returning to the energy industry the ability to grow those markets and make them efficient.

The only legislation I am aware of currently that is pending is that introduced by Senator Feinstein, and she was here to testify this morning about that. I will limit my comments to that bill.

Generally the legislation would address the essential concerns I have outlined in my testimony today. Moreover, the bill hues more closely to the recommendations of the President's Working Group, as well as to many of the expressed concerns of this committee during the debate over the Commodities Futures Modernization Act. Could it do more? Certainly. Is it the right thing to do? In my opinion, yes.

Ultimately, Senator Feinstein's bill is pragmatic. It recognizes the benefits of market innovation by preserving the long-sought legal certainty for swaps. They remain, for the most part, exempt from the CFTC's jurisdiction. At the same time, however, the bill ensures that all transactions in those commodities are fully subject to the Commission's anti-fraud and anti-manipulation authority.

It would not require registration of swap counterparties, but it would require they maintain books and records, something that is probably a routine practice in the industry.

Finally, the legislation recognizes that all exchange markets serve price discovery and hedging purposes and imposes modest transparency disclosure and reporting requirements.

I would be remiss if I did not mention one other aspect of Senator Feinstein's bill that I think is absolutely critical for the Commission. An issue that we have struggled with for some years is the current extent of our fraud authority. Just prior to passage of the CFMA, the Seventh Circuit Court of Appeals indicated that our fraud authority extended only to agency relationships, which means that it would apply only to transactions where there is an intermediary or a broker doing the business on behalf of a customer. Thanks to clarification in the CFMA, we now have some authority over dealer markets in foreign currencies, but our fraud authority continue to be limited in that respect. Certainly it would be similarly limited on the bilateral dealer markets in energy markets for the same reason. Senator Feinstein's bill addresses that prob-

lem in the existing legislation and would fix our fraud authority so that it would apply to non-intermediated markets.

Consumers are the ultimate beneficiaries of properly functioning derivatives markets, whether they are private, like Enron Online, or public, like the NYMEX. By the same token, consumers are the ultimate victims when markets are manipulated or otherwise affected by unlawful behavior. Whether there is anything found in the current investigations of energy markets is really irrelevant. We have a hole in the regulatory regime that allows for fraud and manipulation to operate free from sanction. We have markets experiencing a crisis in confidence. Modest legislation amending the commodities laws is appropriate, in my view, to restore confidence and build integrity.

Thanks very much for your indulgence. I look forward to your questions.

The CHAIRMAN. Thank you very much, Mr. Erickson.

[The prepared statement of Mr. Erickson can be found in the appendix on page 74.]

The CHAIRMAN. I will start with you, commissioner Erickson. Mr. Newsome in his testimony emphasized that the CFTC is proceeding with an investigation of energy trading companies under its anti-fraud and anti-manipulation authority. Your interpretation of CFMA's exemptions and exclusions, however, is that, in fact, it is unclear that the CFTC has anti-fraud and anti-manipulation authority over certain transactions in exempt commodities. How do you explain this?

Mr. ERICKSON. I am fully supportive of any enforcement endeavors that we might undertake. I would just point out that, yes, I am certain and convinced and confident that we do have a gap in what actually is covered by those fraud and manipulation authorities.

I know that you have all been provided with some slides that I have used for some other presentations, and I think that this will also get to Senator Crapo's initial question.

Mr. ERICKSON. On the surface, Section 2(h) of the Act affirmatively does retain and apply our anti-fraud and anti-manipulation authorities to certain transactions. Section 2(g) of the Act is an exclusion for swap transactions, and that provision says that in all commodities except agricultural commodities, swap transactions are completely excluded from the Commission's jurisdiction. That takes them out of the jurisdiction for all purposes, including fraud and manipulation.

The California activity certainly occurred prior to implementation of the Commodity Futures Modernization Act, so I would expect that we will have some activities that are currently under investigation that would be activities that occurred prior to implementation of the Commodity Futures Modernization Act. For those that occurred after, the Commission will have to assess what kind of case we have to move forward on either side of that line.

The CHAIRMAN. Let me see if I understand this. Part of the Act exempts them, and there is another part of the Act that excludes them.

Mr. ERICKSON. Right.

The CHAIRMAN. Which trumps which?

Mr. ERICKSON. Well, that the exclusion trumps and nothing applies. The Section 2(g) transactions are swap transactions that are among sophisticated counterparties.

The CHAIRMAN. Right.

Mr. ERICKSON. They are subject to individual negotiation, and they are also conducted in these commodity markets. There are limitations. The swaps market largely is a market of these kinds of transactions between sophisticated counterparties. They are done with some opportunity for negotiation and they have individual creditworthiness that applies.

The CHAIRMAN. Mr. Newsome, what is your authority, then, to obtain information and oversee the markets and investigate and punish fraud and manipulation if they are excluded? What is your authority?

Mr. NEWSOME. Thank you, Mr. Chairman. There are two points, if allowed, that I would like to try and make, both brought up by Senator Crapo and discussed earlier.

The first point is what was the intent of the President's Working Group toward exemptions or exclusions. We need to point out that the CFMA had the unanimous support of the President's Working Group, so it is very difficult to say that the CFMA did not follow their intent when they unanimously supported the legislation.

The President's Working Group also did specifically address the energy exemption. Some of the discussion we have heard today, certainly while it is very accurate, I do not think told the whole story, and I will quote from the President's Working Group report, which said, "The CFTC should, however, retain its current authority to grant exemptions from derivatives involving non-financial commodities as it did in 1993 for energy products, where exemptions are in the public interest and otherwise consistent with the CEA." The PWG went on to say that, "Nothing in this report should be construed to affect the scope of exemptions that are currently in effect."

The reality was that, administratively, in 1993, the Commission, following the advice of Congress, exempted—had the energy exemption which removed them from Commission oversight. The CFMA codified that exemption.

As we look at the difference between exemption and exclusions, it is very technical and it is very legalistic and at times, I think it is difficult to understand. Obviously, people that are very sincere in fulfilling the mission of the Commission do not agree in all aspects of that. Wise people today have shown that we do not agree in exactly what the language says. I would like to try to address now most specifically your question, what I consider a misunderstanding of the CFMA regarding the Act's exclusions versus its exemptions.

Some have said, and some very sincerely feel that, in effect, the exclusions trump the exemptions, thereby undermining the fraud and manipulation authority of the Commission. In my opinion, this is a misreading of the statute. The intent and effect of the CFMA was clearly not to undermine the CFTC's authority, but to provide legal certainty to markets and tailor regulation to the nature of the participants and to the commodities traded. Simply stated again, swaps transactions were excluded from our jurisdiction prior to the

CFMA by administrative action of the CFTC and they were excluded after the CFMA by codification of Congress. Whether the swaps are in T-bills or in natural gas, the analysis is the same.

However, as Senator Crapo pointed out, the CFMA did provide another level of regulation, that of regulation for exempt commodity transactions that are not determined to be swaps. At this level of regulation, it provides certain fraud and manipulation authorities and, indeed, transparency requirements, as determined by the CFTC. This provision is not related to swaps transactions, nor do I believe that it is trumped by the swap's exclusion for transactions in energy products that are not deemed to be swaps transactions.

The CHAIRMAN. I have some followup questions I will ask, but my time is obviously up now. I turn to Senator Lugar.

Senator LUGAR. Thank you, Mr. Chairman.

Let me just ask each one of you, I appreciate the informed discussion as to exclusion and exemption, what the President's Working Group wanted and what was always there. It seems to me that everybody was operating in a way, as you say, to enhance the CFTC's authority, and likewise, to save the financial system of the country at the time. However, something went wrong.

Clearly, the Enron circumstances—and that is not the only situation, perhaps, but that is pretty evident—was a disaster for a lot of people in America. Leaving aside all the rights and privileges of the traders, as Mr. Erickson has said, the consumers, ordinary people finally have to enter into this situation. We may have worked very hard to make certain that everybody who is a professional in the business, who has a stake and so forth, is accommodated, but we have worked very hard, say, prior to long-term capital management, and that was a disaster of unbelievable dimensions, so complex that most Americans do not realize what might have hit them, but at the same time, we ought to, somebody, regulators, legislators. We got busy and we tried to get our arms around this thing.

I remember going to a meeting involving not only Wall Street people, but Federal Reserve people, and others in the aftermath of long-term capital management. There was an extraordinary gloom about all of our exchanges all over the world among people who were the largest players, leaving aside the public, that only was mildly interested in what seemed to be a debacle of some very bright people who thought they had finally, with Nobel Prize winners, beat the system.

In this situation, the thing I am wondering is Senator Feinstein has come forward with a piece of legislation, but at this point, I would have hoped that CFTC would have come forward with a piece of legislation. In other words, you are the most informed people. You understand the requirements that you have to meet. You are struggling, as you pointed out, trying to go through all the circumstances of Enron or others trying to see whether you have jurisdiction. Whether somebody did something and should be prosecuted, all of that is important, although we are talking today about whether we have jurisdiction at all, quite apart from whether anybody did anything wrong. Clearly, something has to change here.

Now, Senator Feinstein has offered a bill. I have not been one of the original co-sponsors because I hoped that there would be

something forthcoming from those who are responsible and who were informed. Nothing is forthcoming. Essentially, they are saying they need more time. They are still working their way through all the circumstances of this situation.

Maybe because of the discouragement of this, as you pointed out, energy trading is so far down that we temporarily do not have to worry about it, but I doubt whether that will be the case for long.

In my own view, I suppose we will be, in absence of a better alternative, to co-sponsor the Feinstein legislation and try to get it passed. We are going to have testimony today why that is good or bad or indifferent, but there is no doubt in my mind something has got to happen and it is very important it happen quickly rather than in the hereafter, given an egregious failure, and it is every bit of that.

Now, is it possible that the two of you or your colleagues or anybody in the CFTC is going to come forward, really, with some remedy that you think makes sense in terms of the public, not just the traders, not just the pros, but the general public of this country that is looking to you, that is looking to us for somebody to get a handle on something that egregiously is wrong? What do you have to say to that?

Mr. NEWSOME. Thank you very much, Senator Lugar. You raise very legitimate issues and points, and certainly, I am not here to say that absolutely nothing should be done. It is very prudent for we as regulators and you as the Congress to continually look at all legislation to see if it continues to serve the purpose that was intended.

My thoughts simply are this. As Chairman Harkin commented earlier, we spent almost 2 years in the drafting of the CFMA. There were very deliberate discussions and debate leading up to the passage of the CFMA and there was very broad acceptance of what Congress passed.

There are discussions of wide, sweeping changes to the Act that will totally change the regulatory direction that was taken just a short time ago. Certainly, that in order to make such broad, sweeping changes, there needs to be more deliberate debate over whether or not that is the direction that needs to go, what potential impact that could have on markets.

With regulation comes a cost, and in this area, I think very substantial regulatory cost, both in terms of taxpayer dollars to the Commission to fulfill what its new mission potentially might be, and huge costs to market participants. I do not feel comfortable recommending that cost to producers or to market participants until we have spent our time making sure that whatever legislation passes does, indeed, solve the problems that have been created by the Enron collapse and the energy situation.

Senator LUGAR. Mr. Erickson, what is your view?

Mr. ERICKSON. I personally would be pleased to work toward a solution. We absolutely should. It seems that there is general acceptance of the idea that fraud and manipulation ought to apply to these physical commodity markets. Perhaps there are other ways to just cement that in the law. Currently, there is, at best, an argument about whether the law applies in certain situations. That certainty will really build confidence in this market and I would be

pleased to pursue legislative avenues. The unfortunate reality is, it is a legislative solution in this case and I think it is necessary.

Senator LUGAR. The legislative solution Senator Feinstein and others have proposed is that clearly sophisticated traders be subject to reporting, the transparency, the rest of it. The question I raised of her is what about the risks, people dealing over the telephone without records and so forth. Once again, I admit probably a much broader cost, as Chairman Newsome has said, getting into all of that. At this point, my suspicion of the ability of people to create fraud knows almost no bounds when it comes to this energy thing.

We really have to get a handle on it, and this is why, ideally, Chairman Newsome, the perfect would be great and we would have endless meeting of this committee and get the President's Working Group revved up again and so forth. After all of that, let me just simply say, legislatively, it was very hard to get that Act passed. It occurred almost in the dead of night, at the end of a Congress, in the middle of an appropriations hassle. That was not the ideal circumstance. That is the legislative reality of these situations.

I am just saying the Feinstein bill, as you have said, Mr. Erickson, is a modest attempt. I hope while we are doing any attempt, because we do not have very many opportunities, we try to get it as right as we can, but we really need help.

Here, we have Senator Feinstein. She is working from her constituency in California in which people feel badly aggrieved, understandably, given all the public testimony about the manipulation that occurred. This is no longer speculative. People were doing wrong.

What do we do about it, aside from wait for the best solution to come along, and not unintended consequences and all the rest of that? That is not good enough. It just seems to me that we need some help technically from CFTC as opposed to at least rationalizations that the jury is still out. Well, it will be out, I think, for a long while. We have to act, I believe.

Are you about to make another comment?

Mr. ERICKSON. If I might, one of the things that strikes me is that the Feinstein bill really does put these commodities back where they were 18 months ago. To the extent that there was a cost associated with monitoring for manipulation in swaps, it is the same cost. We had electronic trading systems in existence prior to the CFMA.

The difference between before and after, under our regulatory exemptions, is that the agency previously retained its authority. It had the ability to do the investigation where it saw the potential for wrongdoing. The Feinstein bill simply applies fraud and manipulation back to those transactions. I am sympathetic with your concerns about the phone trade, but that has been around. We have had some experience with those transactions for 10 or 12 years.

What she tried to do was pretty pragmatic and just makes sure that fraud and manipulation affirmatively applies to the bilateral marketplace, those transactions that might occur between the two of us. Once you have some kind of a marketplace, whether it is electronic or physical, you have additional transparency obligations that attach because that is where I see, that you run the greatest

risk of price signals being sent, and uneconomic price signals being sent into these markets that can have a manipulative effect. That is why I called the solution that she brought forward to be pragmatic. Thank you, Senator.

The CHAIRMAN. I will proceed in order that Senators arrived to the committee. It will be Senator Miller, Senator Crapo, Senator Fitzgerald, Senator Lincoln, and Senator Nelson. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman, and thank you for holding this hearing.

Perhaps—well, not perhaps, I know that this is oversimplifying a very, very complex issue and problem, but is not what we are trying to get at, all of us, a way to protect the American consumer, not disrupt the success of honest companies, not cripple the entire energy trading market, but protect, as I said in the very beginning, the American consumer?

I want to ask this of each one of you, and if you want, you can just answer it yes or no or you can elaborate as much as you want to. Do you believe that the Feinstein amendment would have prevented the fall of Enron or the California energy crisis?

Mr. NEWSOME. Thank you, Senator Miller.

Senator MILLER. That is, by the way, why I liked your Einstein quotation, of 6 days of looking at what we are trying to get at, the goal, before we do anything else. Excuse me.

Mr. NEWSOME. That is fine. In regard to your specific question, my answer today would have to be no, I do not think it would. If we look at what we know about that situation, we know that energy prices were very high and volatile in the West. We know that there was round-tripping that was confirmed by the companies themselves, and I might add that wash trades are illegal in futures markets. They are wrong, they are fraudulent, and they should be considered such in all markets.

At the end of the day when we look at what created the Enron situation, I think at least it appears that the majority of their problems had to do with accounting fraud, as are a lot of the other companies that we are looking at. Now, that said, that does not mean that we should not take another look at where we are with the CFMA and what is going on.

Certainly, as Senator Lugar suggested, the CFTC is more than happy to provide whatever thoughts, technical assistance to this committee in terms of looking at Senator Feinstein's legislation or any other legislation that could have an impact on the CFMA. As you indicated, Senator Miller, the majority of the people in this business, like any other business, are good people. We all want to make sure, even though we have differing opinions of how to do it, we all want to make sure that the bad players in these markets are removed from the markets and that they are justly punished.

In my opinion, as we look at this situation, it is more appropriate to make sure that we have strong, swift enforcement to serve as the deterrent to wrongdoers, and I would add that as this committee looks at what should be done to the CFMA, my suggestion would be that we need to make sure that we strengthen the Commission's authority in fraud and manipulation and that we strengthen our enforcement actions, and I think that can have as strong a deterrent as anything that we may talk about today.

Senator MILLER. commissioner Erickson, do you think that the Feinstein amendment, if it had been in effect, would have prevented the California energy crisis?

Mr. ERICKSON. Regulation is never a panacea. It does not answer every question. Part of it is the willingness of the independent regulators to exercise their authority. You cannot give any guarantees that the Enron bankruptcy would not have occurred if we had some authority over its trading environment.

Now, there are a couple of points that I would like to expand upon. What we have is a situation where we know that there are parts of this market where fraud and manipulation can take place and it is outside our ability to sanction. That is the hole that needs to be filled. The Feinstein bill does that. It gives us the tools that would be necessary to surveil and have a chance at detecting some kind of risk exposure that Enron had taken on through Enron Online that was otherwise not apparent.

If we had had capital requirements attached to Enron Online, as any banking regulator would have required, we may have had information. I cannot promise a result. It would have given us a chance, a better chance, at detecting any kind of overexposure that they had financially.

Dynegy gave us a real breather during those 3 weeks of November. They came in and held an offer on the table for the merger and acquisition of Enron, and it allowed all these swap counterparties to Enron, either individually or through Enron Online, to reassess their credit exposure to Enron and try and exit those positions. Now, I understand some people were not as successful as others and they still had a day of reckoning where they lost several millions of dollars because of their Enron exposures.

If Dynegy had not been there to allow people to reassess their exposure, we may have seen a little bit more systemic risk in the market and a much more hurtful effect of the Enron winding down, because what we know is the day Enron went bankrupt, Enron Online went dark. If you had been in that marketplace at that point, you would have had naked exposures.

The CHAIRMAN. Thank you, Senator Miller.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. Erickson, as I understand your testimony, your concern—tell me if I am correct about this—your concern is essentially that Section 2(g) of the Act excludes from the fraud, manipulation and transparency provisions the jurisdiction of the Commission over derivatives transactions or swap transactions, is that correct?

Mr. ERICKSON. In all commodities except agriculture.

Senator CRAPO. Correct, in all commodities except agriculture.

Mr. ERICKSON. Yes, that applies to the energy and metals markets.

Senator CRAPO. If I understand Mr. Newsome's testimony, he does not read the Act that way, but if we were to make it clear that Section 2(g) did not exclude these transactions from the fraud, price manipulation, and transparency provisions, would that address your concern, Mr. Erickson?

Mr. ERICKSON. Yes, and it does get to the heart of what the Feinstein bill does. It says transactions, even those conducted pursuant to 2(g), would be subject to our fraud and manipulation authority.

Senator CRAPO. Well, let me get into that, then, because I am reading a summary of the bill—I have not got the bill itself before me, but the summary that I am reading seems to be much, much broader than that. Let me first just ask you a question. Do you believe that all of these other transactions that we are talking about, other than the agriculture transactions and the financial transactions, do you believe that they should all be subject to full coverage, full trading on the commodities exchanges and so forth?

Mr. ERICKSON. Absolutely not. Our history over the last two decades has really demonstrated the absolute need for all of these kinds of derivatives, whether they occur on- or off-exchange. They are integrally linked. They are global markets. They add incredible efficiencies to all commodity markets. I just think in this area of exempt commodities, most of these commodities are of limited supply. Many of them are physical commodities, and our experience with those kinds of commodities is that they are more susceptible to manipulation.

Senator CRAPO. Let me just say, my reading of the act that is being proposed, of the Feinstein bill that is being proposed, is that it literally repeals the definition of exempt commodities, and if I read that correctly, it leaves us with a situation where you are either excluded totally or you are covered totally. Am I wrong in that?

Mr. ERICKSON. I believe the first bill that was introduced, S. 1951, would have eliminated 2(g) completely and would have started out with a new exempt commodities section that would just affirmatively have applied fraud and manipulation authority.

What is in place now is there is no change to the framework, and, in fact, the exempt status of all the exempt commodities is retained. This is absolutely critical for the legal certainty of the transactions so that we do not run into the problem that you previously identified that would potentially force them all onto an exchange environment. That is something that nobody, I think, would make an argument for.

Senator CRAPO. Then we can agree, though, that with regard to the issue that we need to address, as I see it, from your testimony, it is rather specific. We need to address the concern that you have identified with what Section, in your opinion, Section 2(g) has done to the rest of the Act.

Mr. ERICKSON. Yes, and I can maybe provide a little bit more. The definitions of exempt commodity transactions and the swap transactions are slightly different, and that is why I believe 2(g) trumps, because the definition of swap transaction in 2(g) is composed of three parts and the definition of transactions exempt commodities is only composed of two parts. They are nearly identical. In 2(g), if you have the opportunity for individual negotiation, they are excluded. That is why I think it trumps for that broad swath of the swap market, which is 80, 90 percent of all derivatives trading.

Senator CRAPO. It seems to me that whether you are right or wrong about that, at least the issue, as I see it, from your perspec-

tive, is that interpretation of Section 2(g) and the resolution of the issue would be simply clarifying that your interpretation is corrected and that the application is thorough with regard to the fraud, price manipulation, and transparency provisions.

Mr. ERICKSON. That is the heart of the issue. Everything else is providing the obligation for markets to have some level of transparency in their marketplaces.

Senator CRAPO. I assume that you are aware of the testimony that came in before the Banking Committee and in other contexts about the value of derivative transactions to our economy, Alan Greenspan having said that they may have provided the stability that kept us from going deeper into the trough during this last troubled time. Do you agree with that?

Mr. ERICKSON. Absolutely. There is no question about the value of these transactions, and my concern about this market, in particular with energy, is the market is fading away. By attaching some key elements of market integrity to the regulatory regime you would really let the marketplace itself take off again. The participants in energy markets do not have the confidence to trade with one another. Most of the energy platforms that are sanctioned under the law are not in operation today.

Senator CRAPO. Thank you. Mr. Newsome, I understand that you disagree with Mr. Erickson in terms of the interpretation as to whether 2(g) does what he believes it does, but do you agree that energy and minerals transactions should not be subject to full coverage and to required trading on commodities exchanges?

Mr. NEWSOME. It depends upon the trading system and the nature of the participants that are doing the trading, and I think there underlies the premise of the whole CFMA, because the regulatory structure was based upon the product, the type of trading system, and the participant involved in the trade of the product. I would still agree that the criterion in which we should move forward with still should be based upon those different criteria.

Senator CRAPO. Thank you. Mr. Erickson, one last question. Are you aware of any evidence at this point in time that would indicate that a cause of the Enron situation was related to transactions in derivatives?

Mr. ERICKSON. No, I am not aware of any direct evidence. I am concerned, though, that when we have a corporate bankruptcy, a marketplace evaporates.

Senator CRAPO. Thank you.

The CHAIRMAN. Thank you, Senator Crapo.

Senator Fitzgerald.

Senator FITZGERALD. Thank you very much, Mr. Chairman, and at the outset, I would say that I guess we have invited the International Swaps Dealers Association to testify later. I would actually like to hear testimony from ICE, the Intercontinental Exchange, that is lobbying so heavily against closing this loophole because I really think the bill concerns them more specifically than swaps dealers in general. I would hope we could get to hear from ICE specifically, as their owners are a number of large banks that are heavily lobbying Congress not to close this exemption and I would like to hear from them publicly.

I have some questions for both the members, and thank you both for being here. I guess under the old Act and under the new Act, we have the Section 4(c) exemption authority where the Commission can grant a no-action letter. Would it not be better, Mr. Newsome, to go back to the old laws where we had some authority over these now totally excluded energy and metals online trading facilities, and if the Commission wanted to exempt the Intercontinental Exchange or Enron Online, there could be a vote and you guys could send Enron Online a letter exempting them?

Mr. NEWSOME. The 4(c) exemptive authority of the Commission is extremely important, I think, because it gives the Commission some flexibility, and I think flexibility is key in terms of how we move forward from a regulatory standpoint.

Senator FITZGERALD. Even if we closed off this 2(g) exemption, you would still have the flexibility to exempt Enron Online if the Commission wanted to do that. You could have hearings on it. You could take a vote, and if the Commission voted to send a no-action letter to Enron Online or the Intercontinental Exchange, you could do that. You would still have the flexibility, would you not?

Mr. NEWSOME. That may be the case. That is not something that I have looked at specifically. I know that the flexibility of the CFMA, the flexibility of the Commission to utilize 4(c) is extremely important because there is no way we can sit here and look at how the markets might move or what problems we might face in the future, so——

Senator FITZGERALD. Right now, you do not have the flexibility because Enron Online and Intercontinental Exchange are just exempt by statute here with Section 2(g).

Mr. NEWSOME. Exactly. Exactly.

Senator FITZGERALD. You do not have flexibility.

Mr. NEWSOME. Flexibility is a good thing.

Senator FITZGERALD. By closing off 2(g), you would still have the flexibility provided by 4(c). OK. You said that wash trades are illegal in all markets at all times, and I would assume you would mean in energy and metals trading online. Is that the case? Is it illegal to make a wash trade on one of these exempted online energy trading facilities?

Mr. NEWSOME. My Southern slang is difficult to understand, Senator. I said in our markets.

Senator FITZGERALD. In the ones you regulate?

Mr. NEWSOME. In the ones we regulate, there is——

Senator FITZGERALD. You do not have authority to pursue a wash trade in an online energy trading facility, do you?

Mr. NEWSOME. No, I would not say that. To me, when you look at round-tripping or the activity that is taking place, and that is something that we are very aggressively investigating, but when we look at that, I think it brings up two points. One, it appears to me to be fraudulent. Two, we are looking at whether or not that was used to manipulate the market. In either of those cases, it would be illegal and we would have the authority to bring charges.

Senator FITZGERALD. Do you not have the authority to the extent it occurred under the old Act under the authority you had 18 months ago? If the new Act were in effect the whole time these transactions were occurring, is it not true that under the current

Act, you could not go after a wash trade occurring on one of these online energy or metals facilities?

Mr. NEWSOME. I think——

Senator FITZGERALD. Could you point to the section of the Act that would give the ability to go after that wash trade?

Mr. NEWSOME. Unfortunately, I could not point to that section this morning. The new Act took out the specific language regarding the Commission's ability to prosecute wash sales in the type of markets that you are talking about, the exempt markets. However, I still believe that through our anti-fraud, anti-manipulation authority, the Commission has the ability to prosecute in this instance. We are agreeing that we can do it. It may not be quite as simple now as it was 18 months ago because of the removal of the specific wash sale language.

Senator FITZGERALD. Mr. Erickson, would you have a response to that? Do you think you have the authority to go after wash trades in Enron Online under the current Act?

Mr. ERICKSON. No, I do not. I do not think the Commission retains its direct authority to pursue wash sales as a violation.

Senator FITZGERALD. Everybody agrees that wash trades are bad. Do we not want to give the Commission that authority to go after and prevent wash trades? It is an outrage. It was an enormous outrage, what was going on in the energy trading market. Do you both not agree, we want to be able to clear your authority to pursue wash trades?

Mr. NEWSOME. There is no question that they are bad. They are wrong. They are illegal. Given our anti-fraud, anti-manipulation authority, we do have the ability to go after them for that and we are currently investing that.

Senator FITZGERALD. Are these online energy trading facilities not exempt under Section 2(g) from you going after them for fraud? Mr. Erickson thinks they are exempt. You do not think they are exempt.

Mr. ERICKSON. Not only exempt, but excluded.

Mr. NEWSOME. They are exempt. The question is whether or not they are excluded and I continue to believe that we have the authority to go after them for these instances.

Senator FITZGERALD. Are you going to pursue action for trades at Enron Online for wash trades?

Mr. NEWSOME. Sir?

Senator FITZGERALD. Are you going to pursue action against Enron Online for wash trades?

Mr. NEWSOME. We are currently investigating that matter now.

Senator FITZGERALD. OK. Have you encountered any arguments from Enron Online's lawyers that you do not have the authority to do that?

Mr. NEWSOME. I have not spoken personally to Enron Online's lawyers, but I will be glad to followup on that and give you a more specific briefing, Senator, of exactly what we have.

Senator FITZGERALD. Thanks, Jim. Thank you both. I appreciate the time.

The CHAIRMAN. Thank you, Senator Fitzgerald.

I have to leave. My bill is up in another committee and I have to go work that, because it is my bill. Senator Lugar is going to take over and finish chairing the hearing.

I just have to say again that I have been, as I am sure Senator Lugar has been, involved in the CFTC since its beginning in 1975, when I first came on the Agriculture Committee in the House, and I have talked with my staff and I am trying to remember through all those years why it is that we need this exemption. Why is it that we carved out a certain exemption? I know why we did exclusions. That is clear, why we have exclusions, covered by other entities, that type of thing. Why we have an exemption, I do not know. Maybe it is just something we wrote in there to give lawyers a lot of work. I do not know.

I guess I am of the position now that I am thinking that, sort of along the lines of Mr. Fitzgerald, I do not know and I do not want to put words in his mouth, maybe we really ought to reexamine whether or not we need an exempt category. Maybe there ought to be exclusions or not exclusions. If they are excluded, fine. If they are not, you ought to have jurisdiction.

The questions on Enron and stuff, maybe not. Maybe having them regulated and not exempt may not have stopped Enron, but it may have at least precluded whatever part or whatever role the derivatives played in the collapse of Enron. That might have helped to do that. It might have served as an early warning signal to others as to what Enron might have been up to.

I leave the committee and I am going to turn it over to Senator Lugar, but I just ask the question. Maybe we ought to really take a look again at 2(g) and why it is even there in the first place. Thank you very much.

I guess Senator Nelson is next. Thank you, Senator Lugar.

Senator NELSON. Thank you, Mr. Chairman.

First of all, I want to thank the gentlemen for being here and to commend Senator Feinstein for working so diligently with so many stakeholders to come up with legislation that at least addresses the question about structure and transparency, and so I truly appreciate that.

I also would like to note that Mr. Einstein seemed to presume that things might happen in 7 days, 6 days of study, 1 day of decision. I notice more than 6 days have gone by studying and we have not come to the seventh day for a decision about how to fully investigate or get an investigation accomplished.

From my particular perspective, having had Enron located in Nebraska before it suddenly uprooted and went to Houston, with hundreds of people affected with their retirement accounts riddled by the Enron collapse and numbers of people in Nebraska and related to Nebraskans left out of work, it is going to be very difficult for me to go back and tell them that what we have here is a problem of exclusion versus exemption. You can appreciate they are not interested in hearing that. What they are interested in finding out is whether the derivatives issue contributed in any significant way, and if it did at least in part in some way to the collapse of Enron and their complete demise in terms of their financial security, they want to know that, first of all, it has been studied, investigated, and that some appropriate action has been taken.

I have some questions I would like to ask you. First of all, I think I understand, Mr. Erickson, you are suggesting that the Feinstein legislation would, first of all, do no harm, and second, though, the question is, will this grant you the authority to investigate and continue the process that seems to be ongoing right now, to come up with some conclusions about what, in fact, happened, and then second, is it sufficient to protect the public as you move forward.

Mr. Newsome, since you brought up the question of—I will leave Feinstein to Mr. Erickson and I will leave Einstein to you. How much time do we need to take to study before we come to that day when we now decide this is, in fact, the answer?

Mr. Erickson.

Mr. ERICKSON. Are you sure we cannot swap those?

Senator NELSON. No, no.

[Laughter.]

Mr. ERICKSON. You are right on the timing issue. Markets are funny. The next event may be in 1 day, it may be 1 week, it may be 1 year. We cannot really define the time.

With respect to Senator Feinstein's legislation, I continue to look at it as a pragmatic and modest approach. It affirmatively confers to this Commission fraud and manipulation authority, which is essential. The reinstatement of those authorities clearly over the derivatives in these markets would have a prophylactic effect on what people are willing to do.

There is a Governor in place and if people understand that the transactions are subject to some regime, they may temper the questionable kinds of transactions they are entering and the purposes for which they are entering those transactions. They also, may temper the leverage, because I think that is something we really do not remember all the time, that these are leveraged transactions and they operate pursuant to agreements where, if you are concerned about credit, you can ask for a bigger pot of money to be held in basically a deposit account.

I am generally pleased with the Feinstein bill. Yes, it could do more. We could say that if you are running a marketplace where price discovery occurs, it ought to take place in a registered marketplace.

Senator NELSON. A framework.

Mr. ERICKSON. Yes.

Senator NELSON. Transparency.

Mr. ERICKSON. Yes, within our two categories of marketplaces. We have the most highly regulated market, the designated contract market, which is for retail customers. That is what most futures and option markets are today. We also have what currently is an unused part of the framework, which I think is really innovative, and that is the derivative transaction execution facility, which is designed for markets like ICE to find a place in the regulatory regime and yet have a much lighter regulatory treatment.

That is something that is not in the Feinstein bill, but if you really wanted to cement down what kind of transparency you are expecting out of a marketplace, that is something you could look at and just require marketplaces to have some category of registration.

Senator NELSON. Now the question, of course, chairman Newsome, is how much time does it take to conclude the investigation to come up with some conclusion?

Mr. NEWSOME. If you will allow me, I would like to expand beyond that time just to——

Senator NELSON. Sure.

Mr. NEWSOME. It is very difficult to say. We are investigating numerous allegations, of which manipulation is one. Manipulation cases are very complex. They take a lot of time. For example, the two manipulation cases that commissioner Erickson brought up, Sumitomo and Avista, those occurred on our most regulated markets. It is impossible to prevent manipulation. They occurred on the very regulated markets and they were very time consuming. Sumitomo, in fact, took almost 5 years with access to all of the information.

I do not mean to say that Enron is going to take that long because we are very aggressively pursuing that and we have assistance from other agencies and we are going to move as quickly as possible. I cannot give you a specific timeframe because as we go forward, we have uncovered additional information which we have to move on.

I suspect that it is not an all or nothing situation, that there are going to be stages. We are going to finish parts of the investigation. If there are violations, we will bring charges and then we will move forward with the additional parts of the investigation.

Back to your initial comment about constituents, I could not agree more. We want real solutions. If there are problems there, we want to address them. In order for us to look at real solutions, we have to first determine what the real problems are, and therefore, I think the importance of our investigation is we move forward in trying to find out what we have learned.

Clarification and commissioner Erickson and I are in full agreement that clarification of anti-fraud and anti-manipulation authority is a good thing. I mean, if there are players who are not operating by the guidelines, we want to make sure that we have the ability to go out and prosecute those people. I do not think there is any question about that by anyone.

The real discussion goes back to the front-end regulation, when we start looking at market surveillance and transparency. I do not think the debate has been held that what is the real cost to the front-end regulation? What does it mean?

I want to take, for example, transparency. Transparency is like motherhood and apple pie. Transparency is a good thing and we all want very transparent marketplaces, and in markets which we oversee that serve a price discovery function, those markets are transparent and the CFMA gives the authority to the Commission in exempt marketplaces to require transparency if that market comes to serve a price discovery function.

To say that across the board, all of these markets should be transparent is something that deserves a closer look. Transparency in small, illiquid, or very specialized markets could actually have a negative impact. They could distort market prices more than they could help. I do not know that, but we need to look at it, because when you have the non-standard contracts that we are talking

about in many instances in these exempt markets, they are differing in size, they are differing in terms, they are differing in conditions, they are different because of differences in counterparty risk.

What does all of that mean in terms of making this transparent? What kind of distortion could that have on our very standard markets which we utilize for price discovery? It simply needs to be looked at.

Senator NELSON. I thank you for your answers.

Mr. Chairman, if I might just conclude, I agree with transparency and it would seem to me that even though you might have some distortion to the market by transparency in certain cases, that the market would adjust to that over some period of time, that it would recognize and take that into account.

Let me conclude by saying that understanding leverage, only from the standpoint of the insurance industry, it does not matter how much surplus you have against the risks you have taken if you do not have any losses. The reason you compare surplus to the liabilities and exposure of the insurance business is because there are going to be losses and the question is what will those losses be.

I suspect in the case of transparency and in the case of understanding these transactions, you want to know what the potential exposure is if everything goes wrong. Can they withstand that kind of exposure? Hopefully, this legislation would help you be in a position, and/or others looking at the transparency of the transactions, to make that kind of conclusion, not the average person on the street, but those who are sophisticated in this market, in this kind of business.

I thank you. Thank you, Mr. Chairman.

Senator LUGAR [presiding]. Thank you very much, Senator Nelson.

Senator Crapo, do you have additional questions?

Senator CRAPO. Yes. Thank you, Mr. Chairman.

I know we have gone over this before, but I want to be sure that I have it right. As I listened to the testimony of both of you, it seems to me that there is actually a lot more agreement than disagreement with regard to what we ought to be doing and where we ought to be. The disagreement, as I understand it, is over whether 2(g) excludes from the fraud and manipulation provisions swaps transactions. Am I correct about that? Would the two of you agree that that is the core of the disagreement between your testimony?

Mr. NEWSOME. 2(g) certainly does exclude swap transactions. I do not think there is——

Senator CRAPO. It excludes them from fraud and manipulation protections?

Mr. NEWSOME. Two-g excludes them from jurisdiction of the CFTC, period.

Senator CRAPO. All right. Then I guess I am misunderstanding what the difference is. How would you characterize the difference of your testimony, then, Mr. Newsome, between you and Mr. Erickson?

Mr. NEWSOME. In a nutshell, you have the exclusions. You have the exemptions. Under the exemptive category, we have appropriate anti-fraud, anti-manipulation authority. We have appro-

priate authority to require transparency if that market comes to serve a price discovery function.

Senator CRAPO. Regardless of Section 2(g)?

Mr. NEWSOME. Well, they are obviously separate. There are criteria for exclusions under 2(g) and there are criteria for exemptions under 2(h). Another thought process is that 2(g), the exclusion of 2(g) trumps the exemption of 2(h) and I do not think that is correct.

Senator CRAPO. All right. That is what I was trying to say. Mr. Erickson, do you agree with that as the characterization of the difference between you in your opinions today?

Mr. ERICKSON. Yes, I would concur with what the Chairman has said. It is just a matter of how you look at the way these markets are structured, as well. You have the exclusion that attaches just to swaps and swaps are defined by 2(g). My view is that anything that fits in 2(g), is out. It is out as a bilateral transaction, but it is also out if it is done on an electronic exchange marketplace because of another section 2(e) of the Act, which excludes electronic trading facilities.

Senator CRAPO. As I see it, both of you agree that Section 2(g), in the way the Act should be drafted, the Section 2(g) should not exclude these transactions from the fraud and manipulation provisions. Your disagreement is whether it does or not, am I correct in that?

Mr. NEWSOME. Yes. Certainly, when we look at exempt markets, I believe that we should have—I think that we do have the proper anti-fraud, anti-manipulation authority. If there is question about that, then clarification, I think, would be helpful.

Senator CRAPO. Mr. Erickson.

Mr. ERICKSON. Senator, I would just add that I think it would be important to just cement the idea that fraud and manipulation authority apply and attach to the exempt commodity transactions. What you raise may be a distinction that I previously had not seen. For transactions energy products, by dint of being an energy product and exempt, fraud and manipulation authority ought to attach, no matter if you are trading a swap or some other kind of over-the-counter product.

Senator CRAPO. All right. Mr. Erickson, I apparently do not have, or maybe we just got a copy of the latest version that you have been working on of Senator Feinstein's proposal, but I have not read it yet. The latest copy that I read does actually repeal the exempt commodity provisions, and if I understand it correctly, it would then subject all of these transactions to full coverage by the CFTC and trading on the commodities exchanges. That is not what you are suggesting we should do, is it?

Mr. ERICKSON. No. That, I think, is a debate that is taking place a little bit at the hearing today about whether one, two, or three classifications of commodity are appropriate. I am comfortable with the idea of the three categories. The idea of the exempt category was really to make sure that fraud and manipulation attached across the board. That is not the case. I have not seen this legislation. I would be surprised if it completely took out any references to exempted categories, but I will be happy to take a look at it.

Senator CRAPO. All right. Thank you very much.

Senator LUGAR. Thank you. Do you have further questions, Senator Miller?

Senator MILLER. No.

Senator LUGAR. Senator Fitzgerald, do you have further questions of these witnesses?

Senator FITZGERALD. I do. I was wondering about record keeping, whether under current law the online energy and metals trading platforms are required to keep records and are those records available to the CFTC, either of you?

Mr. NEWSOME. I will start. No, there are no record keeping requirements to the section that you are referring to. Do companies keep records? Obviously, they do. As we look at clarifying anti-fraud, anti-manipulation authority, I think we need to look at all activities that could make sure that the Commission has a strong enforcement program and approach to dealing with fraud and manipulation. To my knowledge, I do not believe——

Senator FITZGERALD. They are not required to keep the records, so we could see a bunch of wash trades between these online energy or metals trading firms, and they are not required to keep any records, so even if there was a lawsuit by somebody, there is no statute that requires them to keep records. They could just shred any written records they have and destroy computer records. Do you think that is the case? Mr. Erickson, would you care to comment?

Mr. ERICKSON. It is the case, and it is something that is not required under our Act. Presumably, depending on how you are otherwise—regulated, if you are a publicly held company, there may be some prohibitions on that.

My concern with the wash trading is that there are a lot of different aspects to wash trading. You have the accounting issue. You have the fraud on investors that the SEC would be looking at. With wash trading on these electronic exchanges, it gives people the ability to send false price signals. A lot of these markets are being viewed by thousands of market participants and these transactions are going across these lines potentially and sending a false price, and that is not precluded under the Act as it is written and there are no reporting requirements or other paperwork requirements to require their keeping those. Yes, the answer is they——

Senator FITZGERALD. I grew up and still live outside the Chicago area. Every day, I can open my papers and I can find out the price of a September corn contract or a September pork bellies contract or soybean contract and I can find out the volume of trades on our exchanges in Chicago. Is there anyplace that I can find the same volume price and open interest information for online energy and metal trading firms? Would either of you care to answer that?

Mr. NEWSOME. That information is not widely available, and currently, it is not required to be made transparent. As you know, the Commission has the authority if it makes the determination that these markets serve a price discovery function to require transparency and there are several markets that we are looking at now to make that determination.

We had some of this discussion a few moments ago and I would like to go back, if I may, Senator Lugar, and discuss this with Senator Fitzgerald about transparency. There is no question that gen-

eral transparency in marketplaces is a good thing. This goes toward some of the front-end regulation that is being talked about, and whether or not in these markets, is required transparency a good thing.

I am not going to argue either side of that today, but simply point out that these markets are very different than the standardized markets that you just referred to from Chicago. Some are small, some are illiquid, certainly many are non-standardized. You are talking about a completely different set of, or a different type of information than you would receive on the standard markets in either Chicago or New York, and what kind of impact will that have?

The fact that it is non-standardized, that there are differences in size, differences in terms, differences in condition, differences in counterparty risk, could even the release of that information lead to distortion to some of our standardized markets because of the differences in standards? I do not know that, but I think it is something that we need to look at and something that I think we need to realize when we just talk about transparency in general.

Senator FITZGERALD. Is there any self-regulatory function that these excluded energy and metals trading online platforms have? I mean, what SRO function does the Intercontinental Exchange provide? Does anybody know?

Mr. NEWSOME. To my knowledge, none.

Mr. ERICKSON. None that I am aware of.

Senator FITZGERALD. OK. Now just finally, I guess, if we were to eliminate the exclusion for online trading of energy and metals derivatives contracts or swap contracts, that does not mean that we would be regulating these online platforms in the same way we regulate a facility like the Board of Trade in Chicago or the NYMEX in New York. They could become DTEFs, right, which would be subject to a mid-tier level of regulation, is that not correct?

Mr. NEWSOME. Yes, sir. Still, through the CFMA and as we move forward, I still think it is as important now as it has been to look at the nature of the product, the type of facility, and who is trading the product in order to determine the proper regulatory scheme, and you are correct, they could move into a lesser-regulated——

Senator FITZGERALD. Right now, they are excluded from any category. They do not have heavy. They do not have middle. They do not have light. They do not have any.

With that, thank you both very much.

Senator LUGAR. Thank you very much, Senator Fitzgerald.

I just have a final question. I am intrigued. Mr. Erickson, you pointed out that the lights really went out in the Enron market. Describe what that means. Who was still left in the market and who won and lost in that situation? In other words, most of us have not had an experience in which a market that had considerable volume and a lot of money, the lights just went out, as you suggested. What happened, and describe at least the final day of that.

Mr. ERICKSON. I really think for a lot of this, Senator Lugar, time will fill in many of the gaps in the details that we have. I just personally think it is striking and shocking, really, that you could have an event like that where a marketplace is just gone. That is

why I look at this from the perspective that we really dodged the bullet. We had this period of 3 weeks where the operations were able to continue.

Senator LUGAR. In other words, the Dynegy situation you described that allowed traders who were in this market to disengage——

Mr. ERICKSON. Exactly.

Senator LUGAR [continuing]. That is, to close their positions, sometimes at losses or whatever, but to get out. They were not there when the lights went out.

Mr. ERICKSON. Exactly.

Senator LUGAR. But, now, somebody was. Who was there when the lights went out?

Mr. ERICKSON. I have made a couple of unfortunate statements in various public places and I think that we are all under the impression that virtually everyone did have the opportunity to exit. I made that statement to a group of pretty good-sized energy companies in Texas about a month ago and was quickly taken to task for making that statement with a few folks saying that they were not so successful as I might otherwise have presumed and that they had just delayed taking several million dollars in losses for a period of months.

I do not know the scope of it, but I think that we were able to dodge a bullet. It was just luck in this case. To the extent something like this happened again and we did not have some willing buyer out there, people may have just been left in that market and unable, really, to trade out, and that concerns me.

Senator LUGAR. I will not argue the transparency thing. Mr. Newsome has made a very good case that we need to take a look at all the source of that issue.

This Enron market strikes me as something that was not very transparent. As a matter of fact, even though some of us knew that such a thing existed, what was going on in there concerning not very transparent—now, some would argue, no need to be. You have sophisticated people. They were aware of their risks and so, therefore, back in the back room if people are being clobbered, that is their tough luck.

The dilemma is, of course, when huge sums of money are taking place like this, some of the people had other stockholders, had some public consumers that were behind them, why, there are some implications for people other than these sophisticated persons. They were not operating as individuals, I suspect, most of them, with their own net worth in these markets. This is what I am worried about, is the fallout. Something that was meant for people who were very sophisticated but in their operations, others are caught in the wake of this.

I have no idea who was there, and that is why I was just simply curious. You say most, somehow, given the Dynegy, scrambled and got free of it and reported their losses, hopefully by this time, do not have bookkeeping problems of their own, describing what they were doing back there in the markets. This is something that, it seems to me, between the Commission and the committee, we have to grapple with, not that that was the end of Enron. Lots of other things happened before. Our particular piece of the situation we

take seriously, derivatives, commodities regulation. We really want to make certain we perfect as much as possible the Act that we were all involved in a while back, and so that is the purpose of my querying this.

We thank both of you very much for your testimony. Both Chairman Harkin and I have allowed members of the committee as much time as they needed, and likewise you, because it was very important that this be a part of our record as we are literally consulting together in the midst of a public hearing. We thank you for coming.

Mr. ERICKSON. Thank you, Senator.

Mr. NEWSOME. Thank you, Senator.

Senator LUGAR. The chair would like to call now our second panel that will include Mr. Randall Dodd, Director of the Derivatives Study Center; Mr. John Coffee, Professor of Columbia Law School; Mr. Neal Wolkoff, Executive Vice President of the New York Mercantile Exchange; Mr. Ernest T. Patrikis, Senior Vice President and General Counsel from American International Group, Incorporated, International Swaps and Derivatives Association, ISDA; and Mr. Richard Green, Chairman of Aquila, Incorporated, of Kansas City, Missouri.

Gentlemen, unlike the more permissive regime that has operated in this committee this morning thus far, let me ask each one of you, if you can, to summarize your testimony in 5 minutes. We will not be rigid on that because in some cases, that may be impossible. Given the hour and, likewise, retaining the attention of members, we would like to hear from each one of you ad seriatim and then have opportunities for rounds of questions as committee members might desire.

Mr. Dodd.

STATEMENT OF RANDALL DODD, DIRECTOR, DERIVATIVES STUDY CENTER, WASHINGTON, DC

Mr. DODD. Thank you very much. I wanted to start by saying I am very honored to be here today and I want to be able to provide my insight into the nature of derivatives markets and to also offer an economic analysis that will probably help us better understand what should be the proper level of regulation in these markets.

Now, unfortunately, though, we are being brought together today by a large number of problems that have cast a pall over our financial markets. Some of these are sort of bad apples—executives, accountants, auditors, financial analysts, people reporting in the media, but there are also a lot of bad non-apples, failures in our accounting rules, our financial reporting rules, but also failures in the way we have used derivatives.

I would like to focus on the role of derivatives today because I think that we need to solve the problem of the way we treat over-the-counter derivatives in order to solve the problems with these accounting rules. In fact, I do not think it is going to be possible to solve accounting, auditing, and financial reporting problems without more transparent derivatives markets, and I believe we cannot expect to maintain safe and sound and orderly trading markets for commodities and for other financial instruments until we have the same basic rules applying to over-the-counter derivatives

markets as we have with banking, security, and insurance. Let me elaborate on those points in order to justify them.

The over-the-counter derivatives markets, as we know, have grown rapidly in the last 20 years. Chairman Harkin mentioned that they are now $111 trillion worldwide, quite a bit of that here in the U.S. It is now multiple times the size of our GDP.

If you compare these markets to the size of our securities markets or banking markets or insurance markets, they certainly rival, if they do not exceed, them. Today, derivatives are very much the fourth leg of the table that might be thought of as comprising our financial system. However, unlike the other legs of the table, banking, securities, and insurance, there are no regulations substantially regarding these over-the-counter derivatives markets, aside from some semantic difficulties we have seen in trying to define that subset of them known as exempt commodities.

The reason derivatives have grown so much is because they provide two very important economic functions, that is, price discovery and risk shifting or hedging or risk management. They have also grown because they provide some unproductive uses, some downright nefarious uses, and we have had those highlighted to us due to the failure of Enron. We have seen that they can be used to hide debt, hide losses, fabricate income, conduct wash trades, to manipulate markets. They also can be used to avoid taxes. They can also be used to avoid or outflank the regulations that apply to banking, securities, and insurance. We have seen how they can fabricate a loan by using, for example, offsetting forward contracts in natural gas. Also, prepaid swaps have done the same thing.

We need a regulatory framework that encourages their use for risk shifting and for price discovery while prohibiting their use for these unproductive, if downright nefarious, activities. That is the goal here today and I am hoping to help in doing that.

Given that these derivatives markets are large, they are an important part of the economy, and might I add also they are an especially important part of the energy industry. Our $600 billion use of energy every year involves a large number of derivatives contracts. We do not know exactly, of course, because there are no reporting requirements and so there is no hard data on the amount of derivatives, over-the-counter derivatives in energy products or metal products.

However, I did take the opportunity a few months ago to estimate the size of Enron's derivatives book. Enron alone had at the end of 2000, the last year they reported, $758 billion worth of derivatives in energy products on their books. Now, you add to that Duke, Dynegy, Williams, El Paso, Aquila, the others, and you have the size of an energy derivatives market in the U.S. that is multifold the size of this $600 billion use of our energy, so those markets are very important.

Because they are important, it is important that they work efficiently. The conditions for these markets working efficiently are that, one, the prices are transparent, that everyone can see them. Everyone can also see market volume, open interest, and the like. Also, that large traders' reporting data is given to the government authority so that we can detect and deter manipulation.

Transactions in these derivatives instruments should also be conducted in a way that is orderly, where markets do not just freeze up, they do not just suddenly stop trading, where there are not excessive price movements. After all, that is the way we treat the New York Stock Exchange and that is the way we treat our other exchange-traded instruments.

Last, derivatives instruments should have proper credit management practices. Derivatives dealers should have capital. Derivative instruments should have collateral attached to them that is adequate for the risks that are involved in those transactions.

Now, those are what is needed for an efficient working market that is tied to this key energy and metal and other financial markets in our economy. Yet, we do not see that actually occurring in the market today. The private sector has not produced market practices that are consistent with those needs for an efficient market, and that why I think it is so good that we can come here today to talk about what might be the remedies for this problem, and I would like to propose in the brief time I have remaining three basic remedies to this problem.

The first one is to establish registration and reporting requirements for over-the-counter derivatives. Anyone dealing, selling, participating in the transaction should be registered. They should have a background check to make sure they have not been convicted of fraud or embezzlement. If you get convicted of securities fraud, you are barred from that industry for life as a securities broker, but tomorrow, you can go get a job working for Dynegy, El Paso, or Williams, and that is a tragedy. Also, the institutions should be registered so we know who they are.

Finally, they should also have reporting requirements. Enron and the like had no reporting requirements as a derivatives dealer. We know very little about them. We can only infer a little bit, what we get from their quarterly and annual statements. They should also report their large trader positions to the government so that we can detect and deter manipulation and other market problems.

In addition to registration and reporting, the second thing we need is collateral and capital requirements. Enron had no capital requirement as a derivatives dealer, even though they were a large financial institution. Similarly, for that matter, GE and some of these other near-financial institutions also have no capital requirements. It also would apply to the El Paso, Williams, and the others. As a result, when Enron fails, the effect is not buffered and instead is felt immediately by other participants in the industry and, in fact, other firms throughout the economy, and today we have this pall over our entire financial market.

In addition to capital is collateral requirements. The organized futures exchanges, such as NYMEX, have margin and their clearinghouse has capital and that is why when Enron failed and this market started to melt down, there was a flight to quality, and where did they flee to? They flew to the high-capitalized, well-margined markets in the NYMEX and they were able in some cases to get out of Enron and into that market to protect themselves from credit failure or performance failure on their derivatives contracts. If it were not for that flight to quality, for having a safe harbor of where to go, surely the consequences would have been much more

difficult. To avoid the deeper problems in the future, we need to start thinking and establish today about how to adequately collateralize these contracts.

In addition to reporting and registration requirements, capital and collateral requirements, last would come what I would consider orderly market rules, and these would require the derivatives dealers to act as dealers do in other markets, which is to maintain liquidity by posting bid and ask prices throughout the trading day. It is used in the over-the-counter market for U.S. Government securities. It is even required there. It is used on the stock exchange as the specialists maintain bid/ask prices. It should also be the case for over-the-counter derivatives dealers in order to maintain an orderly market and market liquidity.

We should also have spec limits and we should also have excessive price movement limits, again, just as we do in the New York Stock Exchange and the other futures exchanges. This will help make these markets more efficient. It will help prohibit the unsavory, nefarious, unproductive uses that we are witnessing today, and I think it will go a long way to try to solve the problems that have been highlighted by the failure of Enron and the subsequent calamities that we have seen in our financial markets. Thank you.

Senator LUGAR. Thank you very much, Mr. Dodd.

[The prepared statement of Mr. Dodd can be found in the appendix on page 90.]

Senator LUGAR. Mr. Coffee.

STATEMENT OF JOHN C. COFFEE, JR., PROFESSOR, COLUMBIA LAW SCHOOL, NEW YORK, NEW YORK

Mr. COFFEE. Thank you again for inviting me. I want to briefly address three questions. First, will the Feinstein amendment produce undesirable uncertainty, and my answer will be no. Second question, do we need greater transparency in the energy derivatives market, and my answer will be yes.

Third, the question I think we really should be focusing on in most detail, are there any aspects of the Feinstein amendment that might produce undesirable or unnecessary restraint on future competition within this industry, and my answer here is yes, there might be. The amendment is a good answer, a workable answer, but probably not the optimal answer. There is some over-regulation in it that is not necessary for its basic core purpose.

Now, let me remind you of something you already know, but I think the record should set this forth clearly, the 2000 Act was precipitated by a turf war between the SEC and the CFTC, and as a result of that, there was suddenly a serious question about the legal status of swaps and the possibility that the longstanding 1993 swaps exemption might be repealed suddenly. That sent a friction of fear across Wall Street and the President's Working Group understandably recommended that financial derivatives be deregulated to the extent they traded over-the-counter.

Now, the President's Working Group, as you all know, did not extend that recommendation beyond financial derivatives, and in a very simple sentence, we ought to state the rationale for that, which Senator Fitzgerald has stated and you have also repeated, but it should be fully in the record. The position of the President's

Working Group is that financial derivatives are not vulnerable to manipulation, corners, or swaps because they have infinite supply, whereas physical commodities are vulnerable to corners and swaps because there is finite supply, and that has always got to be your polestar when you come back to exempt commodities.

If there is a physical commodity or there is something that is in finite supply, there is a potential for manipulation, and the most important thing to take from Senator Feinstein's very succinct testimony this morning was that there has been a wave of wash transactions and they raise the strong inference, the strong smell that there is a manipulative intent in someone's mind. Investigations will tell us later who did it, and I raise no charges, point no fingers, but if you get those many wash transactions, someone has improper purposes someplace and you have to respond to that.

Now, let me go back to the three questions that I raised. First, is there going to be undesirable legal uncertainty if the Feinstein amendment were passed? Well, I think not because the SEC is now out of the picture. There is no possibility again that we will have a swap being alternatively characterized as a future by one agency and an option by the other agency because the SEC's jurisdiction has been taken away.

The issue that comes up in this area is whether or not the exchange traded facility, ETFs, deserves to be regulated on a totally different basis than the futures exchange. Now, as a generalize, I would start out this analysis by looking at the status of Nasdaq and the New York Stock Exchange. They differ in the same way that the electronic traded facility, the ETF, differs from the futures exchange. One has open outcry, one is electronic. They are different in the same way that our current energy market is different with two kinds of trading institutions. Both Nasdaq and the New York Stock Exchange are regulated the same way when it comes to transparency, reporting, and disclosure, and I think that, again, should be the polestar. There are relevant differences. Nasdaq is not yet an exchange. They have the same obligations when it comes to fraud disclosure reporting obligation.

There has been an issue raised about whether the overlap of the FERC and the CFTC will also give rise to undesirable competition or undesirable uncertainty, and I would have to point out that the FERC and the CFTC are very different agencies with very different regulatory missions. Thus, they should overlap. The CFTC is basically an investor protection agency and the FERC is basically concerned with consumer protection. It is not safe to cut one agency back when the other agency's jurisdiction begins because they are trying to protect different constituencies and they have different priorities.

The second question, is there a need for greater transparency? Again, I think that the Feinstein testimony this morning pointed out that there is a huge volume of wash transactions, and what is the motive for a wash transaction, the dominant motive? Maybe not the exclusive motive, but the dominant motive is to send a false price signal, a false price signal that signals either that there is demand at a particular price level or that there is market depth and liquidity at that particular price level, and that is a signal that can distort not only the market that the signal is entered into but the

other market. The fundamental question is, why do we have to regulate a market full of only sophisticated participants, and the answer is because false signals can be sent from that market that have an externality, that create an externality, because they affect other markets.

Again, as a generalist, let me take you back very quickly to 1987 and the Brady Commission, which was one of the most authoritative studies after the 1987 stock crash of how markets operate, and they developed the one market concept. There was an issue about whether certain transactions in stock index futures in Chicago destabilized the New York Stock Exchange and what they concluded was that there was a realistic scenario that when information was suddenly suspended from Chicago and you no longer knew what was happening in the stock index future market, that that could send a wave of fear and change trading behavior on the floor of the New York Stock Exchange.

This concept from the Brady Commission carries over today. There is one market and we have two functional substitutes. We have futures exchanges and we have electronic trading facilities, and while I think both should survive, both should be encouraged, they should be allowed to compete fairly, we have to recognize that signals from one market will affect both markets. We have to have integrated functional regulation that treats them similarly to the extent there is a danger of deception and a danger of lack of transparency, because transparency affects the other market, as well.

Last question, is there a danger of over-regulation? I heartily endorse the transparency, the disclosure, the reporting requirements. The burdens of that kind of regulation are small, the benefits are great, and the injury to other participants is enormous because the lack of transparency affects other markets. There is always that externality.

I am more concerned about some other areas that I think are necessarily adopted. For example, the net capital rules, I do not think that the net capital rules should be imposed on the electronic trading facilities. I do not think that serves anything like the same purpose of ensuring disclosure. The net capital rules are basically there from the broker-dealer history to protect retail customers against the danger of broker insolvency because brokers hold money and property.

I am not sure we have the same need to protect paternalistically the users of electronic trading facilities. Now, I have used that just as an illustration. There is a certain amount of over-breadth in the proposals and I think the core idea of ensuring that there be greater transparency, greater disclosure and regulation is necessary, vital, and fairly low-cost, but I think there is some excess regulatory baggage that at least should not require a priority and it could deserve some further examination.

At this point, I will stop and take any questions that you later want.

Senator LUGAR. Thank you very much, Mr. Coffee.

[The prepared statement of Mr. Coffee can be found in the appendix on page 130.]

Senator LUGAR. Mr. Patrikis.

STATEMENT OF ERNEST T. PATRIKIS, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN INTERNATIONAL GROUP, INC., INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (ISDA), NEW YORK, NEW YORK

Mr. PATRIKIS. Thank you, Senator Lugar. I would like to start off by saying that every morning when I get up, I wonder what disgusting new story will surface from the deeds of certain members of corporate America. I joined AIG 4 years ago after a 30-year career at the Federal Reserve Bank of New York. I was the No. 2 officer of the bank. In moving to the private sector, I asked myself, how would it stand up compared to working at the Fed as far as ethical matters were concerned, and to date have not found that a problem, but I find all of us tainted by what is going on in the marketplace today.

That is much of the theme of the statement that we have submitted to you this morning. The horrendous activities generated by a few represent a failure of corporate governance and ethics. It would not be accurate or fair to blame Enron or any of the lapses of business morality on the over-the-counter derivatives. A better question is, what is wrong with business school curriculums?

Your inquiry is timely. You should be asking the questions you are asking. We appreciate Senator Feinstein's concerns about what happened with electricity and natural gas trading in California. At ISDA, we believe the case has yet to be made that regulation of OTC swaps in privately negotiated derivatives as futures is warranted. While I am not an expert in derivatives or in energy trading—perhaps I know enough to get myself into trouble—I have read accounts of energy trading activities in the press but have learned over the years not to believe all that I read.

I understand that the FERC and the CFTC, which, in our opinion, has ample authority to address fraud and market manipulation with respect to non-financial derivatives, has several investigations underway. I hope that the committee awaits the results of those investigations before deciding on a legislative course.

Of course, there are many questions surrounding energy trading. Some of these relate to California's electricity and natural gas deregulation regime and how it may well have invited traders to take advantage of it through proper and improper means. One key issue here is whether improper activities involved any use of over-the-counter derivatives as opposed to cash-settled spot trades.

In any event, the major issue you have posed is whether the CFTC has the authority to deal with fraud and market manipulation that might involve OTC non-financial derivatives. That question has been best answered by the Chair of the CFTC this morning. At ISDA, we share that view. We believe the CFTC has that authority. However, if it is ultimately determined that it does not, then we will work with you on legislation to provide the appropriate agency with that authority.

You are probably asking yourselves, why does ISDA oppose legislation that would regulate OTC derivatives as futures? The answer is that it would result in less liquidity in the marketplace and would create new uncertainties. As the members of the President's Working Group on Financial Markets have pointed out, OTC derivatives are a valuable risk management tool used all over the

world. They are a form of financial insurance, spreading risk or loss to those who can best bear it.

Businesses that are now carrying on activities that would in the future subject it to regulation may well stay away from markets that they now use to hedge risks, or they might shift risk management activities offshore. These non-financial derivative markets are not public retail markets similar to those of the futures exchanges, where futures style regulation is needed. These markets are composed of sophisticated participants. If there is a lack of liquidity in some of the energy markets today, it probably does not result from the lack of regulation but is a market, including rating agency, response to the fact that trading profits do not make up for lack of capital or that more capital is needed to cover trading risks. We need more, not fewer, participants in these markets.

It is not clear to me that the legislation proposed would address the alleged electricity and natural gas trading abuses. Futures regulation for these OTC derivatives will not stop fraud. Indeed, as I recall it, several past infamous cases of market manipulation involved significant use of futures exchanges.

In closing, the Commodities Futures Modernization Act is about 18 months old. It has brought needed certainty to the OTC derivatives market, not through deregulation but codification. This has made it possible for businesses and other OTC derivative users, including governments, to better manage their risks.

It assisted in the Enron situation. Enron counterparties did not walk away from their trades. Your work on the Commodities Futures Modernization Act and support of bankruptcy legislation aided the markets to work as well as they could in a difficult situation. In addition, even though Enron was the largest bankruptcy to date, it did not lead to systemic failure in the markets.

Let us give the FERC and the CFTC the opportunity to finish their work before we conclude that legislation is the answer. Thank you.

Senator LUGAR. Thank you very much, sir.

[The prepared statement of Mr. Patrikis can be found in the appendix on page 138.]

Senator LUGAR. Mr. Wolkoff.

STATEMENT OF NEAL L. WOLKOFF, EXECUTIVE VICE PRESIDENT, NEW YORK MERCANTILE EXCHANGE, WASHINGTON, DC

Mr. WOLKOFF. Mr. Chairman, thank you for allowing me to be here today. Thank you for holding the hearing. My name is Neal Wolkoff. I am the Executive Vice President and Chief Operating Officer of the New York Mercantile Exchange. The NYMEX has the world's largest regulated energy marketplace, and as far as precious metals, I can say the same thing.

For myself, my career in commodities regulation and market operations goes back 22 years, initially as a trial attorney with the CFTC's Division of Enforcement, and for the last 20 years specifically working in the areas of energy and metals marketplaces. I will do my best to distill that 20 years into the 5-minutes permitted to me. If I go over, feel free to cut me off.

A little bit of context is very helpful because there has been an awful lot said today, all of it obviously well meaning, but much of it incompatible.

To start with, swap transactions or unregulated over-the-counter derivative transactions are their own instrument. Nobody is saying that they should be treated like futures transactions. Nobody is looking for them to be put into the same box as regulated futures transactions.

A little bit of history, prior to the CFMA being adopted, in the early 1990's, I believe it was 1991, as a result of a case involving a Brent transaction which threw legal uncertainty into the energy cash marketplace, the CFTC adopted the energy swap exemption, which the NYMEX supported and we are big believers in liquid and competitive cash markets, and that includes over-the-counter swap transactions.

In 1993, to provide legal certainty to all swaps, including financial swaps, the CFTC adopted what was called Part 35, and Part 35 set forward standards for what participants could appropriately participate and also established that swap transactions could not be standardized and, likewise, could not be cleared, which were two distinctions that were made with the exchange traded world.

The CFMA then effectively overrode Part 35, and I think Professor Coffee established perfectly sound reasons why that took place. It excluded financial swaps from CFTC oversight, which was consistent with the President's Working Group. It allowed for standardization in energy and metals contracts, which was consistent with what the marketplace had been evolving to, and it permitted the clearing of energy and metals derivative transactions because following Long Term Capital and various other near misses, there was a belief that perhaps clearing was not something that should be withheld from the over-the-counter market but encouraged.

Those were generally pretty good things. Part 35 applied prohibitions against wash trading. It made fraud impermissible as far as swaps, and it outlawed manipulation if conducted via swap transactions, all very straightforward and simple. There was no confusion until the jurisdictional dispute came into effect, none of that having anything to do with energy and metals.

The CFMA with respect to energy and metals swaps removed the prohibition on wash trading and, in fact, it created regulatory uncertainty, as we heard the two commissioners, the chairman and commissioner Erickson before with respect to the application of the anti-fraud and anti-manipulation rules on those over-the-counter markets.

Much about the CFMA has been beneficial and forward-looking in a number of respects, but it is important to note that by permitting metals and energy swaps to become standardized and traded on electronic trading systems, the law enhanced the roles of those over-the-counter markets in price determination of very important strategic commodities, which metals and energy clearly are. Transactions previously had been individually negotiated and tailored to the needs of the two parties. The resulting price was both hard to compare, as suggested before, because the transactions themselves were so different, and there was no vehicle to publicize the transaction price to the wider marketplace.

Electronic transactions provided that vehicle and standardization allowed the comparison of transactions so that parties could easily see what a particular standardized instrument was trading for. It was not dissimilar in particular from the price dissemination function that a regulated exchange has.

In doing some very good things, however, there were some regulatory black holes that were created, and I will not get into the history of how the law was adopted. It was recognized that there was some particular perhaps carelessness. It would not be the lesson in civics that I would want my small children following.

Under the CFMA, certain markets, including, for example, the Enron Online system—which is still in business, the assets of that system are now used by USB Warburg and many of the same traders and management is now working for USB—falls outside of the definition of a trading facility and it is clearly outside the CFTC's regulatory powers.

Other markets that operate in the new regulatory tier called exempt commercial markets, they do not have transparency to the broader marketplace. You need to actually be a member or an active participant in order to have the screen. Yet, they serve a vital price discovery function because the participants are generally the larger users, producers and merchants of the particular commodity and they are using these systems to determine what their price should be. The CFTC, without doubt, does not have effective tools to conduct oversight of these markets or to deter wrongdoing or punish wrongdoing once it is uncovered.

The CFMA, finally, removed the prohibition on wash trading, which previously under Part 35 applied to all of these transactions, and it is hard to imagine what public benefit would accrue for companies freely being allowed to wash trade under commodities law. I have scratched my head on that quite a few times and it is still not apparent.

How can Congress fix these problems? Clearly, I am here supporting the Feinstein amendment. Perhaps there may be some tweaking on capital provisions, but I think that is a very small item. The Feinstein-Fitzgerald amendment is pragmatic, it is moderate, and it is narrowly tailored. It preserves legal certainty for swaps. It still exempts transactions from prescriptive regulation. It does not tell companies what to do and how to do it. It tells them that if you do things in a fraudulent or manipulative way, you can be punished for that. That is not saying, do it this way but not another way. It is not prescriptive regulation. That is very important. Importantly, as well, it provides the CFTC tools to ensure accountability and transparency and to deter misconduct.

It seems difficult to understand why we would want to have educated people and attorneys argue, and eventually argue in front of a judge, an argument similar to how many angels are on the head of a pin. Does the CFTC, in fact, have jurisdiction over this transaction but not over that transaction, not really depending on the nature of the trade but where the trade occurred? Those are the kinds of technicalities that I think people find outrageous when there is wrongdoing but there is no clear avenue of investigation or punishment. That is not good deterrence and that is not effective for an appropriate market.

With the Feinstein amendment, it provides for an application clearly across the board of anti-fraud and anti-manipulation rules and the prohibition against wash trading is clearly and evenly applied across the over-the-counter market that remains regulated.

In fact, we believe that the Feinstein-Fitzgerald amendment should be enhanced and improved in one regard, and that is that the CFTC should have discretionary authority to create certain self-regulatory obligations on the part certainly of the larger centralized electronic systems that are playing a key and important role in price determination. Otherwise, the burden to surveil the market and enforce rules would fall entirely on the CFTC, which is a resource drain to government regulators.

The commercial platforms, in our view, should stand behind not just the technology of their systems, but the integrity, as well, and we have provided specific language to Senator Feinstein's office in this regard.

Last, I would just like to conclude, why does NYMEX care about this issue? As stated before, we have been unambiguously supportive of the various swap exemptions since the early 1990's. A liquid over-the-counter market gives business to NYMEX. It is good for us. It is good for competition. It is a pro-competitive move. What these markets have lately done to themselves, unfortunately, is not pro-competitive. It is not good for the marketplace. It is not good to NYMEX.

It is a bit scary, in fact, when you consider that under recent electricity deregulation, the generation has been taken away from the utilities and provided to the merchant class, which, as said before, has now lost $188 billion of market capital during the last year. They are controlling power generation. This is a bit of a frightening world here at this point.

Does this bill solve everything? No, it does not solve everything. Is it a good step forward to what it intends to solve? Yes, it is, and we heartily support it. Thank you, Senator.

Senator LUGAR. Thank you very much.

[The prepared statement of Mr. Wolkoff can be found in the appendix on page 152.]

Senator LUGAR. Mr. Green.

STATEMENT OF RICHARD C. GREEN, CHAIRMAN, AQUILA, INC., KANSAS CITY, MISSOURI

Mr. GREEN. Thank you, Chairman Lugar and members of the committee. As Chairman of Aquila, I appreciate the opportunity to testify today and want to emphasize that I am speaking for Aquila today and not anyone else in our industry. You should understand that Aquila is an integrated energy and risk management company based in Kansas City, Missouri, with customers and operations across the United States, Canada, Europe, New Zealand, and Australia. We own traditional investor-owned utilities in Missouri and Kansas, Colorado, Nebraska, Iowa, Michigan, and Minnesota. We also own and operate generation, transmission, distribution, and gas storage facilities.

Until recently, we were very active in the energy trading business, both in electricity and natural gas. In fact, we were in that business from its inception 17 years ago, rising to be consistently

the nation's No. 2 or No. 3 trader in natural gas or electricity. Recently, we initiated a restructuring that included a significant downsizing of our trading operations for both electricity and gas due to the tightening credit and capital requirements for energy traders.

I have three main points that I want to make today. First, it is clear that the Enron collapse has had an enormous impact on shareholders and employees of energy trading companies, irrespective of the company's track record or its soundness. A crisis of confidence exists, especially from rating agencies and capital markets.

Second, I need not tell this committee how valuable derivatives have been for agriculture. Derivatives are no less important in the energy industry. The loss of a substantial portion of energy traders will ultimately have an adverse effect on energy supply and prices as competition diminishes.

The third point that I want to make is that it is critical for bodies such as this committee to work quickly to remove uncertainty from the markets, to make corrective remedies where warranted, and to allow the energy industry to get back to the business of building critically needed infrastructure. The entire energy sector has experienced a state of upheaval since the California energy crisis and the Enron bankruptcy. The troubling effects of these events have expanded to affect all energy traders, even those who had nothing to do with either the California market or Enron's inappropriate practices.

My company withdrew temporarily, but significantly, from the California markets in the fourth quarter of 2000. We saw instability in the market, which made the level of risk to participate too high. Moreover, we did not engage in the kinds of improper accounting or trading practices for which Enron has become notorious. We played by the rules. Yet, we as well as many others were swept up in the same wave of uncertainty and lack of confidence that has resulted in credit downgrades and investor flight. Consequently, a substantial portion of the trading industry has reduced their trading activities or withdrawn altogether.

The Commodities Futures Modernization Act of 2000 was a significant step forward for financial market development. Its primary act was to provide legal certainty for the over-the-counter or off-exchange derivatives markets. Congress provided the legislation necessary to enable companies to actively engage in transactions with derivative products, to manage their price risks, and provide stability in their business.

We at Aquila do not believe that the current CFMA led to the crisis in the industry. We are not sure that one can put the responsibility on the wording of any specific Federal law. Today, we believe that the Act gave ample authority to address fraud and market manipulation. However, we are here to decide whether the current law should be modified, given the current situation.

We believe that restoration of public confidence in this industry does require revision in the current law. The current business climate, not just in energy, is, frankly, perilous. The difficulties are both structural and psychological. The country as a whole has been distrustful about business ethics, financial reporting, accounting practices, and the use of financial instruments, such as derivatives.

Companies have gone out of their way in annual reports to say that they do not use derivatives. Credit agencies, in response to the Enron collapse, are exercising heightened scrutiny of energy companies using business practices that were perfectly acceptable only 3 months ago.

You have a right, and perhaps an obligation, to ask, does the activity of energy traders add value to the marketplace and do energy initiatives matter? The answer is, yes. Derivatives have been shown to be a critical factor in investment and growth of the economy. By utilizing futures, options, swaps, Aquila and companies like it are able to take price risks from someone who does not want it and distribute it to someone who will accept it. The use and value of derivatives in the energy industry is no different than the more mature industries like agriculture and banking.

Chairman Harkin earlier asked about how these derivatives affect people. Well, here are a couple of examples. Aquila has a custom derivative product called the guaranteed bill that a Midwestern regulated utility offers to its residential customers that provides for a fixed monthly bill on natural gas with no surprise adjustment at the end of the period.

Another example of the benefits of customized derivatives is our contract with the Sacramento Municipal Utility, which provides them power or cash when there is insufficient rainfall for their hydroelectric generation to operate. This allows the Sacramento utility to protect its customers from rate increases to cover the costs of purchasing last-minute power at high prices on the open market during periods of drought. These benefits need and should continue.

We urge this committee to take action to quickly put remedies and safeguards in place to help restore the confidence in the beneficial reliance on energy derivatives. To that end, we at Aquila especially appreciate Senator Feinstein's willingness to listen to industry concerns as she moved forward with her proposal. S. 1951 ensures that information necessary for review and oversight by the CFTC to do its job is provided on a timely basis. We support Senator Feinstein's latest version of her bill as it provides the necessary safety nets to restore public trust while not impeding the dynamics of the marketplace.

These proposed changes in the current law will increase transparency through better and more detailed reporting of transaction data, give the appropriate regulatory agencies abundant and unambiguous authority to investigate anti-fraud and anti-manipulation tactics that have been so critical in destroying investor confidence, and require for bilateral dealer markets the use of value-at-risk models, or in very limited circumstances and where the Commission determines the risk demands it, the application of minimal capital requirements. These measures will provide the openness and accountability so that we start the task of rebuilding confidence in the energy trading industry.

I have talked a great deal about public trust, the importance of instilling it. I know that this committee will do what it can to restore certainty in the marketplace and provide protection for consumers. However, it will be up to corporate America to behave in

a way that earns the public trust. Thank you for the opportunity to appear before this committee.

Senator LUGAR. Thank you very much.

[The prepared statement of Mr. Green can be found in the appendix on page 164.]

Senator LUGAR. I want to thank each one of you for extraordinary testimony, and by unanimous consent, all of the testimony you have offered in prepared form will be made a part of the record, in addition to comments that you made this morning. This abbreviated testimony was a desire to make sure all could be heard.

Let me just at this point defer to my colleagues. We are going to have a roll call vote on the Senate floor, I understand, in about 3 minutes' time, and that will probably effectively bring to a conclusion the hearing this morning. Before that occurs, let me call first of all on Senator Fitzgerald.

Senator FITZGERALD. Thank you. Mr. Patrikis, I gather you are from the International Swaps and Derivatives Association.

Mr. PATRIKIS. I am a Director of the Association, yes.

Senator FITZGERALD. I have been reading the prepared testimony during the course of this hearing and I wanted to ask you some questions about it. You state in the prepared testimony a very good case for legal certainty in the financial derivatives industry, but I do not think anybody is arguing about the need for legal certainty. Everybody agrees that there is that need and nobody wants to undermine that. However, in non-financial commodities, such as energy or metals trading online, do you not think it is reasonable to have a prohibition in the Act against wash trades?

Mr. PATRIKIS. What we heard today was that the CFTC believes that it already has jurisdiction to deal with that. If that is the case, as the Chairman of the CFTC said, I agree with him. Wash trades are bad——

Senator FITZGERALD. Well, we had, I would say, substantial conflict on that. Mr. Erickson said he did not believe they do and Mr. Newsome was not quite so sure.

Mr. Coffee, you are a law professor. Do you think the CFTC right now could pursue an online energy exchange for wash trades? Is there that——

Mr. COFFEE. There is a regulatory hole. If 2(g) is read with a plain meaning analysis, it says there is no authority over someone who falls in 2(g). There could be issues about whether Enron online truly qualified as an electronic trading facility. I am not saying litigation could not try to fight at the edges as to whether you fell within 2(g). If you fall within 2(g), the plain meaning says there is no authority.

I understand Mr. Erickson's position. Commissioner and chairman Newsome was a little bit more equivocal, and I am not sure I fully understand the basis for his position.

Senator FITZGERALD. Mr. Patrikis, you agree wash trades should be banned, that they should not be legal.

Mr. PATRIKIS. Correct.

Senator FITZGERALD. You think they should be banned?

Mr. PATRIKIS. No, I think they are banned. If the issue is—we get back to the same question again. If they already are subject to the authority——

Senator FITZGERALD. They are banned on the NYMEX or the Chicago Board of Trade. Everybody agrees with that. I have been looking through the Act, trying to find someplace where the CFTC would have authority to go after a wash trade on Enron Online, now owned by USB Warburg, or on the Intercontinental Exchange. I do not find it. You just had a distinguished law professor say he does not see it. Mr. Wolkoff, do you believe that the CFTC has that authority right now?

Mr. WOLKOFF. No. It is unambiguous. Under the rules preventing wash trading, specifically state that they apply to futures transactions, the Part 35 prohibition, which was explicit in applying wash trading prohibitions to swaps. That language has been removed in 2(g) and 2(h). Regardless of which section you believe Enron Online or any of these other facilities falls under, the wash trading provision is conspicuously not there. It is simply not there and you cannot imply a statutory prohibition when the statute expressly excludes the prohibition.

Senator FITZGERALD. Now, given that confusion, Mr. Patrikis, what is the problem with making it clear that the CFTC, for example, could go after and pursue enforcement actions against people engaging in wash trades on these online energy and metals exchanges?

Mr. PATRIKIS. I said in my statement this morning that if the CFTC does not have authority to go after these trades, it should have the authority. The difference is, does it have the authority? I go with the Chairman. I work for a chairman. I like to follow that chairman. We have heard the Chairman of the CFTC speak. I assume he has a general counsel who is helping him. He thinks he has the authority.

I say, first, let us wait and see what the abuses are. Has it involved swaps or does it involve cash spot trades, and then see if he has the authority he has. He says he has the authority. We think he does. I am not an expert in this area of the law, but he speaks for the Commission.

Senator FITZGERALD. I have an article from the Chicago Tribune right here talking about wash trades and saying that they have occurred in the online energy industry. It seems clear enough for the Chicago Tribune, which is a very careful newspaper. They say that wash trades are used to inflate numbers on both sides. They serve no other economic purpose. They have a chart here, one company selling a power contract to the other company at a certain price and that other company selling it right back to the first seller at the same price, returning the power. Also, both sides are recording revenue from these sales.

The Tribune asks, why do it? They say companies could use these sales to inflate their numbers, making the companies appear bigger than they really are. Then they ask, is it legal? They say, because the wholesale energy market is not regulated, such transactions appear to be legal. Similar sales, however, are prohibited in regulated financial markets. Now, according to the Chicago Tribune, I am saying that this is the Chicago Tribune saying this—I

have not independently verified it—but they say CMS Energy Corporation, Dynegy, Inc., and Reliant Resources took part in wash sales.

It seems to me we have a lot of people saying this is going on. Why not let us just make it crystal clear that the CFTC has the authority to ban these wash trades? Is there any public benefit to wash trades? Does anybody want to defend wash trades?

[No response.]

Senator FITZGERALD. Nobody wants to defend it. It seems to me that one of the reasons I understand the NYMEX's volume has been going way up is that people are migrating away from these unregulated companies, companies that have no regulation at all. People do not want to participate in that now after all the disclosures have come out about abuses in wash trades in the energy market, and I do not even think it is in the long-term best interest of companies such as the Intercontinental Exchange to fight some simple level of regulation that would bring some transparency and some ability to ban practices that everybody seems to agree should be illegal, like wash trades.

I wonder if Mr. Wolkoff could address what has happened to the NYMEX's volume recently.

Mr. WOLKOFF. For the first 6 months of this year, our energy volume is up about 30 percent, and due to a number of factors, but one of which clearly has been the loss of market confidence in over-the-counter markets. Notwithstanding that, I think that for the long-term health and well-being of the market, it is not a positive that there is a loss of confidence in the over-the-counter markets and I do not think it is a positive going forward for market competition and I do not see it as an ongoing positive for the NYMEX to have this situation.

Senator FITZGERALD. I could actually argue that you should maybe be arguing on the other side, let us not close this loophole, because you are benefiting from it. All this business is migrating from the wild West over to where customers have some confidence that there is some ability on the part of regulators to ban fraudulent practices and to have some price discovery.

Senator LUGAR. Senator Fitzgerald, let me just interrupt for a moment, if I may, to recognize our colleague, and then we will come back.

Senator Crapo.

Senator CRAPO. Thank you very much. I would like to just get into a couple of quick issues. One of the allegations that is very regularly thrown around here is that the Enron collapse is somehow attributable to the failure to properly regulate derivatives, and I have asked most witnesses we have had before us on this issue if they are aware of any evidence of that fact. Is anybody on the panel aware of any evidence, and I am not talking about this argument about impact on prices in the market in general of improper uses of swaps or whatever, but is anybody on the panel aware of any evidence that shows that the Enron collapse is attributable to the derivatives market?

Mr. DODD. I can offer an explanation. If you look at, first, the role that derivatives were used to hide the debt, hide the losses and fabricate income, and generally distort their balance sheet and fi-

nancial reports in a way that caused the larger market to lose confidence in Enron, I think in the first act, they played a very critical role in undermining that market confidence and sending Enron into deep trouble.

Now, when that happened and people ceased to trade with Enron Online because no one wanted as a counterparty an entity whose credit rating was in a great deal of doubt because their past reporting was not what they thought it was, and when people——

Senator CRAPO. So——

Mr. DODD. Just one last point, please, sir. I am sorry. When people ceased trading with Enron Online, then they lost liquidity. They no longer made their income as a dealer. They no longer earned their bid-ask spread. That was the remaining profitable part of the corporation, and then they no longer had a profit source.

Then when their credit rating did drop and they were hit as sort of being super-margined, by having to come up with more collateral for their derivatives contracts, that was, in fact, the day they declared bankruptcy because that is when they could no longer feasibly operate and the lights went out on the trading platform.

Senator CRAPO. You are testifying that Enron's use of derivatives contracts is what allowed Enron to distort its financial picture?

Mr. DODD. Yes. They used them in conjunction with the special purpose entities to hide debt. They moved it into these special purpose entities, as you recall, right, and showed that they sold the products for an exaggerated price, and then they used the swaps to then pay back the Enron parent a profit from the transaction, so they reported that as income. They also borrowed money, as we saw in this case with the insurance companies, from J.P. Morgan Chase——

Senator CRAPO. Now were those, what we are seeing here, called the illegal swap transactions or the wash transactions?

Mr. DODD. They were legal, and I think that is one of the problems, that it is not just a matter of bad apples but we have some bad rules.

Senator CRAPO. Legal or not, were they wash transactions that you are talking about?

Mr. DODD. Some of them were, some of them were not. It goes beyond wash transactions because it was not even with another entity. It was just, if you will, within Enron, between the parent and the——

Senator CRAPO. Well, that is my point. If you are saying that a derivatives transaction was used in one of these other relationships that you are talking about, I mean, a regular contract that we all learn about in contract law in law school could have been used, as well. Does the fact that you can find a totally legal derivatives transaction involved in the Enron circumstance, does that mean that the derivatives transaction itself was suspect?

Mr. DODD. I do think it was an unproductive use of the derivatives contract to avoid financial reporting rules to disclose their debt from their investors, and in that regard, I do think the derivatives were critical——

Senator CRAPO. I am having a hard time seeing how a derivatives contract could be used to avoid financial reporting rules.

Mr. DODD. They used them not to avoid the rule. They used them to outflank the rule, if you will, because they moved their debt into the special purpose entities. They disclosed some of the losses by moving those into the special purpose entities through these derivatives trades. Then to cap it all off, they sold their stock to some of these special purpose entities to enable the special purpose entity to pay off a profitable swap they did back to the parent Enron and they reported that as income.

Senator CRAPO. Mr. Patrikis has been trying to get in here. Let us let him——

Mr. PATRIKIS. It is a little difficult to conclude that swaps caused Enron's collapse.

Mr. DODD. I did not say caused.

Mr. PATRIKIS. Well, are a major contribution.

Mr. DODD. I said they were used——

Mr. PATRIKIS. I would like to continue testifying.

Senator CRAPO. Certainly. Go ahead.

Mr. PATRIKIS. That the firm lacked profit. It had losses. It made acquisitions. It could not afford it. It had debt. It could not cover its debt. It did everything it could to hide the debt. It used a variety of sources to do it. I do not think swaps was a major contribution to that. The company had a good name. It was able to sell off these SPEs to parties who were dealing with a good name. That is the source of it.

As to the Enron dealing subsidiary, we heard today, well, Dynegy saved everybody. As Enron's trading subsidiary got into trouble, it was willing to close out trades with counterparties, as is typical in the case. If we want to know who was hurt by Enron, want the trading subsidiary, we can go to the bankruptcy court and see that there were companies who were in the money, who owed Enron money, they had trades that were favorable to Enron that were not closed out and they are debtors of the estate. They will be paying money into the estate. The swap agreement provides for this.

The fact that people were able to close out trades was not due to Dynegy, it was due to this legislation that this committee has fostered, including the bankruptcy legislation, that allowed orderly close-out of trades. That is something ISDA and this committee have worked on very hard. That the work this committee did helped facilitate Enron not being a systemic situation.

Now, the companies dealing with Enron were much better off than we go to long-term capital management because of risk management. The companies in this business have market risk and credit risk people working. We at AIG do it through our profit centers where there is market risk and credit risk and we do it at the holding company overlooking it. Those firms manage their risk well. We had losses from Enron. The losses were containable. The losses were not material. Why? Because we managed risk.

That is a better part of the Enron story, is how can you have the largest bankruptcy in the history of the United States and not have dominoes. It shows, yes, people will make mistakes, people can be misled, shareholders can be hurt, employees can be hurt, but it was managed. We can contain it.

Senator CRAPO. Mr. Coffee, you are the law professor here and so you have been approached several times in questions on that

issue. Let me just go to you on this. I realize that there is an investigation underway and we may find more, but based on what you are aware of at this point, is there any evidence that you can see that the use of derivatives or swaps by Enron caused its collapse?

Mr. COFFEE. In my judgment, on the available evidence, Enron's failure was caused by accounting irregularities and corporate governance failures. There may be some, what I will call spurious hedging, in which Enron moved assets from its left pocket to its 97-percent-owned right pocket, but I do not think that that reflects on the market as a whole. That was self-deception by which Enron convinced itself and its shareholders that it did not have liabilities that it really did have, and I consider that to be fundamentally a corporate governance failure and an accounting failure.

Senator CRAPO. Thank you. I realize my time is running out, as well. Thank you, Mr. Chairman.

Senator LUGAR. Thank you, Senator Crapo.

Gentlemen, Senator Fitzgerald has indicated that he wishes to return and ask some more questions. I hesitate to ask you to stay indefinitely, and I will not do that. We do have a roll call vote underway, so I am going to declare a recess of the hearing pending the reemergence of my colleague, Senator Fitzgerald. At that point, he will preside over the meeting as he completes his questioning.

I want to take this occasion again to thank each one of you for your extraordinary patience. This has been a hearing now of well over 3 hours, but one that I believe has been productive for our understanding and for that of the public. We will proceed at least as constructively as we can on the basis of the wisdom you have given to us.

For the moment, the hearing is recessed, and I will ask the staff to at least be referees in terms of a reasonable time. I presume my staff will be back soon. He left that impression as he departed. At a reasonable time, in the event he does not return, then the recess should be concluded and the hearing adjourned. I thank each one of you.

[Recess.]

Senator FITZGERALD [presiding]. Thank you for sticking around. I just have a few remaining remarks and I think the other Senators are probably headed to the lunch now following our vote, but I do want to give each of you the opportunity to wrap up your thoughts on the issue.

I do want to call to everybody's attention, on July 6, just a few days ago, in the Washington Post, they reported, "Energy Firm Restates by $7.8 Billion," and if I could read you this paragraph, "Reliant Resources restated its results for a 3-year period during which the company said it engaged in trades that artificially inflated its revenue by more than $7.8 billion. It said cash-flows, operating income, and net income were not affected. In its filing with the Securities and Exchange Commission, Reliant said, 'round-trip trades' the company engaged in during 1999, 2000, and 2001 should not have been reflected in its revenues or expenses. The trades added $6.4 billion to the company's revenue during that period. The company's revenue also was inflated by nearly $1.5 billion because of how it accounted for four other energy contracts. Reliant described those deals as swaps."

Professor Coffee, would you care to comment on what I just read to you, what implications that has for our discussion here this morning?

Mr. COFFEE. I would say that the obvious implication of that article is that that company, a publicly held company, must have believed that the CFTC lacked jurisdiction over these kinds of transactions. Now, they could have been right or they could have been wrong, and I understand that there is a sincere, good faith belief of some in the CFTC leadership that they do have jurisdiction. The industry does not agree with them and we once again have legal uncertainty, and I think the simplest way to resolve that is for Congress to speak. They could resolve this question much quicker than would be the process of litigation if the CFTC found an appropriate case to bring.

Senator FITZGERALD. Now, you are a securities law professor, correct? In fact, did I have a textbook of yours? Did you write a——

Mr. COFFEE. There may be. I am co-author of the best-selling securities regulation textbook.

Senator FITZGERALD. How long has it been out?

Mr. COFFEE. It was the first one. It is in the ninth edition now. It came out in about 1980.

Senator FITZGERALD. Well, I graduated from law school in 1986, and so that may have been your casebook. I guess you might be responsible if I do not know enough about securities laws. You might be partly responsible.

Mr. COFFEE. I am responsible for thousands, then.

Senator FITZGERALD. Clearly, Reliant could have a securities law problem, possibly——

Mr. COFFEE. Oh, certainly. There is no question that they have overstated their revenue. They may not have overstated their net income because this is a wash transaction.

Senator FITZGERALD. Right, but the SEC might take the position that the revenue and the expenses from those wash trades should not have been included in their statements, their financial statements.

Mr. COFFEE. Certainly, that is a point that the SEC could raise, but I thought for purposes of this hearing it seems to me strongly apparent that the company must have felt that it was not illegal to engage in wash trades, which is the critical question for this body.

Senator FITZGERALD. For CFTC purposes. Now, Mr. Patrikis, you seem vastly outnumbered, I think, based on——

Mr. PATRIKIS. That is OK.

[Laughter.]

Mr. PATRIKIS. My first question really is, is the Washington Post better than the Chicago Tribune in terms of the accuracy of the reporting? I do not know what "swaps" means in this instance. I do not know if it is two spot trades back and forth. It sounded like there were two simultaneous trades the same day. I do not know enough. I will go to the Financial Times, February 19 of this year, the need for better financial reporting, the SEC and proposals for accounting regulatory board will deal with that. It seems to me the issue like this wash trades also, but the accounting side, public

companies doing things like that to puff up the balance sheets. It is just a despicable practice all around.

Senator FITZGERALD. Do you think this problem could be addressed just by the SEC making clear that wash trades should not be accounted for on the income statements, and then, therefore, there would be no reason for a company to engage in wash trades because you would not get the inflated revenue from the wash trades?

Mr. PATRIKIS. No, I do not say that. I say that is one reason why it is bad, and wash trades are bad and the CFTC says it has jurisdiction over wash trades. It is doubly bad.

Senator FITZGERALD. Now, do you think there are any banks, for example, that engage in interest rate swaps, for example, that amount to wash trades? Do you think that is going on? That is really not the subject of the Feinstein bill——

Mr. PATRIKIS. I have never heard of it. I do not know what they would accomplish. The interest rate in our markets is set in the Federal funds market. It is the largest free market, outside the government securities market, in the world, and the only person who manipulates that market that I know of is the Fed, which presumably does it legally.

Senator FITZGERALD. Would anybody care to comment on that? Does anybody think wash trades would be going on with financial——

Mr. COFFEE. It would not be going on with the purpose of trying to create a short-term spike in the market price. It might occur in the energy market, but the real motive was not to overstate your revenue but to create a short-term spike in the market price to affect consumer prices.

Senator FITZGERALD. To establish a price. There would be two reasons for a wash trade, one to goose your revenues, but two, also to set a fictitious price.

Mr. DODD. Senator, I think, also, it raises the next question. We focused a whole lot of our time here just on ascertaining whether or not the Commission has authority over wash trades. Even once we have clarified that and established it once and for all, you are still left with the critical problem of how are they going to enforce that, and without reporting requirements, they are going to have a very hard time actually enforcing that prohibition in any effective way, and I think it is worthwhile pointing out at this juncture, then, how easy reporting requirements and how costless reporting requirements are because people that trade derivatives nearly all through the instant master agreement, they all confirm the trades through electronic messages between the counterparties.

All that is required to report this vast world of over-the-counter derivatives transactions is to "cc" the government on the electronic confirmation messages, and that would give an extraordinarily cheap and standardized audit trail and paper trail for any supervisor to use to try to detect this activity. You could, if it was properly standardized, just do a computer algorithm to run through the data to catch trades that occur between counterparties on the same day at the same price. Those are things that could be made available to regulators for practically nothing.

Senator FITZGERALD. Would there be another possibility, and I will get to Senator Crapo and certainly give him plenty of time. There are a lot of motivations that people could be opposed to Senator Feinstein and my amendment, but one of the concerns I have is that with a lack of transparency on online energy trading platforms and metals trading platforms, is it not possible for the customer of that facility to not be getting the best price?

Could I call Enron Online, or USB Warburg Online now, ask them to pick up a natural gas contract for me at, say, 265? Could they then go online, and maybe they could buy it at 263 but sell it to me at 265? I would really never know that I got shaved, would I, because I have no ability to—there is no transparency in this market. Would Mr. Wolkoff want to address that?

Mr. WOLKOFF. I do not actually think there is anything illegal about that. Many participants in the market would simply say that that is good trading unless there was some sort of a brokerage, a fiduciary duty between them and you.

It becomes very hypothetical and I think that there are many possibilities, and part of the problem right now is that without knowing the realities, people are free to have imagination run wild, because there are some pretty bad stories that have been confirmed, including the ones you have read, out in the——

Senator FITZGERALD. A retail investor could not go online——

Mr. WOLKOFF. No. The retail investor is prohibited unless they meet certain asset requirements which bring them into a sophisticated investor category, like $10 million of net worth type of thing.

Senator FITZGERALD. Then could that sophisticated investor call Enron Online and ask them to buy a natural gas contact for them?

Mr. WOLKOFF. I am not as familiar with exactly how that system works now, but my understanding of it is that they are not operating in a brokerage capacity. They are operating as a principal in a market, and so that when you do business on that platform against UBS, UBS is a buyer or a seller and you, as the counterparty, are the reverse of that. If UBS is able to sell to you at a higher price than they have been able to buy from somebody else, they owed you no obligation to lose money on your behalf. They are not a fiduciary in that regard. If it were a system where they are operating as a broker, essentially, where they are taking orders and then taking obligations——

Senator FITZGERALD. Who is trading on those online energy platforms?

Mr. WOLKOFF. Nowadays?

Senator FITZGERALD. Yes.

Mr. WOLKOFF. Very few. In the past, it was——

Senator FITZGERALD. Well, who would be some of the examples?

Mr. WOLKOFF. Many of the merchant companies. You have the large——

Senator FITZGERALD. Could you give some examples?

Mr. WOLKOFF. AEP, Aquila, whether on that particular system or not, you certainly had Enron, you had J. Aaron, you had Morgan Stanley. These are large participants in the energy world, Dynegy. I am sure Mr. Green would be more adept at reeling these names off.

Senator FITZGERALD. Mr. Green, you are a part owner of the Intercontinental Exchange, correct?

Mr. GREEN. Yes.

Senator FITZGERALD. You also trade on that exchange?

Mr. GREEN. To a lot lesser extent today, since we are shutting down the business, our selling business.

Senator FITZGERALD. You do favor some, even though you are an owner of the Intercontinental Exchange, you do favor some greater regulatory oversight?

Mr. GREEN. Oh, no question about it. What we have seen happen in this marketplace and the colossal breach of trust by corporate America, we have to start building it back and you do not build it back by saying, let us wait and see. You start taking steps, and that is why we are in favor of your amendment.

Senator FITZGERALD. The other owners of the company do not agree with you, is that correct, and that is why they have Mr. Patrikis——

Mr. PATRIKIS. No, we do not participate. To the best of my knowledge, my company does not participate in it.

During the break, I talked with someone about it since I did not understand it, and I will try to give you how I think it works, but maybe Mr. Green can correct me. Instead of a telephone, we have a computer facility that allows parties to be introduced to each other. It replaces the telephone. There is no broker. There is no intermediary. There are a standard contract similar to the foreign exchange market or the interest rate swap market. There are some basic terms that are standardized in it.

In order to go into business, ICE has to file notice of its existence with the CFTC. It has to tell the CFTC that its owners are not criminals. It has to make its rules available to the CFTC. The CFTC has online connection. It has access to the trading platform for information.

Two counterparties in the marketplace, two of these sophisticated investors are introduced to each other and say, let us do a deal. Then they go offline and they negotiate the credit terms. Do I want collateral?

I also think the system has built into it that——

Senator FITZGERALD. They go offline?

Mr. PATRIKIS. They have to then negotiate the credit terms. In other words, I may require collateral of you. I may require collateral of you if my exposure to you is more than $10 million or $25 million. The credit risk is managed bilaterally, or I think the system has built into it that I just may not do business with a certain party. I do not like Goldman Sachs. I can say I will not do any trade with Goldman Sachs because I already have too much credit risk to Goldman Sachs.

We finish negotiating the terms of the swap agreement. It is the terms that are the financial terms of the transaction are standardized, but then we go offline. This just replaced the telephone. That is all it has done, is replaced the telephone and through these standard terms makes it easier to do business.

My understanding from what we heard from the Chairman of the CFTC today, if this system, which does not have retail, does not do clearing, and may not do price discovery, if it becomes a price

discovery vehicle, then the CFTC has jurisdiction under the existing rules. I do not know what he was—when he was referring to what they were looking into, but——

Senator FITZGERALD. What section of the law gives——

Mr. PATRIKIS. I am not an expert on this statute.

Senator FITZGERALD. Now, if two sophisticated principals like you just described were trading agricultural commodities in an online platform like that, that would be regulated by the CFTC. They could ban wash trades. What is the public policy rationale for picking out energy contracts, which are also in finite supply, just like agricultural commodities and other non-financial commodities, and metals contracts, which metals also have a finite supply, what is the public policy rationale for this special carve-out for energy and metals? Why do they get this special treatment?

Mr. PATRIKIS. I, frankly, do not know, and we heard this morning from earlier witnesses, I do not think there is anyone around that does, who did the deal. The people who did that transaction had a motivation. I do not know what it was.

Senator FITZGERALD. Who put the bill together?

Mr. PATRIKIS. Right, in conference.

Senator FITZGERALD. As we had it in Senate committee, it did not have that special carve-out and somehow, this——

Mr. PATRIKIS. In conference.

Senator FITZGERALD [continuing]. Special carve-out came and it does not seem to have a father. No one can figure out who did it.

Back to Mr. Green. Have you talked to the other owners of ICE about this issue, and how many owners of ICE are there? Is there publicly available information? I know I have seen some reports of who the owners are.

Mr. GREEN. I would think so. I am not sure. There are maybe 15. I am not really sure.

Senator FITZGERALD. Some banks, some energy companies, right?

Mr. GREEN. Yes, and certainly, and that is why I said in my testimony very clearly I was speaking for Aquila and not beyond that, because there is not unanimous agreement on how we approach this situation.

Part of it is an effort to keep the good, positive effect of derivatives going on in the market like what we have done in Sacramento and what we do with homeowners in the Midwest and their gas bills, you need an over-the-counter off-exchange market to be able to put together those derivatives.

Take the Sacramento derivative that we have with that municipal utility. When you talk about putting a package together that starts to take away rainfall risk and power price risk and a list of other risks, you need to be able to go over and put all those risks somewhere else and that takes a complex kind of conversation with sophisticated players. It is not a simple, standard commodity that you could do on the NYMEX. There is a need for that.

Now, at the same time, we need transparency and make it open so you cannot have other things happen, but there is a need for that, in general.

Senator FITZGERALD. Senator Crapo, you have been waiting patiently, so please, take your time here.

Senator CRAPO. Thank you very much, Mr. Chairman.

Actually, you asked the question that was going to be my first question, although I was going to ask it a little differently, and I will ask it differently to see if it evokes a different piece of the response.

As I read the Act, and I am trying to learn just what happened myself when the CFMA was passed, it creates three categories, one called excluded transactions, which are financial derivatives; one called everything else, which are exempted derivatives—one is called everything else but agriculture transactions, and that is called exempted transactions as opposed to excluded transactions; and then there is agriculture.

My question is, why was agriculture carved out? Does anybody know? I mean, agriculture is all by itself——

Mr. DODD. Farmers would not prohibit the bill from passing.

Senator CRAPO. Is that what it was?

Mr. DODD. Yes, sir, I think that is a very succinct answer.

Senator CRAPO. Basically, the agriculture community wanted to be an exchange-traded market, and had it not been for the agriculture position there, they would have been in the exempted category.

Senator FITZGERALD. Can I clarify that a little bit?

Senator CRAPO. Sure. If anybody can clarify it, I would appreciate knowing.

Senator FITZGERALD. There are three levels. I mean, there is full regulation like you have at the Boards of Trade in New York and Chicago. Then there is a middle-tier category for online trading facilities. Then there is no regulation for, like, financial derivatives. Even if you were to trade agriculture commodities, I think it would be possible, if you were to trade them online, you would get this middle-tier regulation.

Senator CRAPO. That is not how I read the Act. Is that correct?

Senator FITZGERALD. All agricultural commodities have to be traded on—it would be impossible to set them up—Mr. Wolkoff?

Mr. WOLKOFF. My understanding, and it may not be a perfect understanding, is that agricultural——

Senator FITZGERALD. You could not have the DTEF, in other words, that——

Mr. WOLKOFF. Agricultural commodities could be traded on a DTEF but could not be traded on an exempt transaction facility. The three levels are contract market, which is a regulated change; a DTEF, which is a hybrid of an unregulated market and a regulated market; and an exempt transaction facility, which is where, say, the Enron Online and the Intercontinental Exchange fall out. As an exempt transaction facility, you are not permitted to have under that exemption agricultural commodities trading. It does not obligate——

Senator FITZGERALD. OK, but you could trade them on a DTEF, right?

Mr. WOLKOFF. I believe that is correct, only with certain participants.

Senator FITZGERALD. You could trade them on a contract market, like the Board of Trade——

Mr. WOLKOFF. I did not hear you. I am sorry.

Senator FITZGERALD. You could trade agricultural commodities on a contract market or on a DTEF but not on an exempt——

Mr. WOLKOFF. That is my understanding.

Senator CRAPO. That would be my understanding. The definition is really clear for exempt commodities. It is everything that is not excluded and not agriculture.

Mr. PATRIKIS. One of the reasons is there was no over-the-counter market for agriculture at the time.

Senator CRAPO. They did not want one to become.

Mr. PATRIKIS. The committee did not want one to become.

Senator CRAPO. OK. I guess——

Mr. PATRIKIS. I would like to go back to what Senator Fitzgerald—I have been handed a cite for you, Section 2(h)(4)(D), which provides for anti-fraud, anti-manipulation, and does give the CFTC the price discovery authority on——

Senator FITZGERALD. Section 2(h)(4)——

Mr. PATRIKIS. Section 2(h)(4)(D).

Senator CRAPO. That is the one I was looking for earlier today. Mr. Erickson referred to Section 2(h). I assume that is what he was referring to.

Let me go on then. I guess the answer to why agriculture is treated differently is basically that there never was a different treatment of agriculture and the committee just decided to keep it that way and the agriculture community wanted it kept that way. What I am understanding here is that agriculture was treated as it is now in what I would call the fully regulated category. Then we created the other two categories, which is financial transactions, which are commodities which were excluded, and everything else which was exempted. Am I in the ballpark?

Mr. WOLKOFF. At the risk of further muddying the waters, there are also a category called forward contracts——

Senator CRAPO. Great.

Mr. WOLKOFF [continuing]. Which are unregulated cash, physical delivery contracts in which—a very common transaction for agricultural contracts to be traded forward from the planting through the harvest season, of course——

Senator CRAPO. That would be in the agriculture arena?

Mr. WOLKOFF. Well, it is not a derivative. It is a forward contract, so that is really a physically delivered marketplace that is unregulated but not covered by either the Feinstein amendment or the 2(h) section.

Senator CRAPO. All right. From there, then, I am assuming from what I have heard from every witness today that there is nobody who is suggesting that we should treat the exempt category or everything but financial transactions and agriculture, that we should treat that category like agriculture. Does anybody here believe we should just move the exempt category into the agriculture category?

Senator FITZGERALD. Nobody is for requiring them to be traded on a board of trade like the Chicago Board of Trade and subjecting them to the full-blown regulations.

Senator CRAPO. That is what I understand. That is what I wanted to get clarified. OK. We have all these categories, and it is

agreed by everybody that the exempt category is a legitimate category that needs to be maintained and we may need to revise——

Mr. COFFEE. I would want to clarify that I think what is really driving these distinctions is not the nature of the category but the nature of the trading market. Many of these commodities trade among very sophisticated parties. Agriculture has classically traded among farmers who are retail players in these markets, and for that reason, we wanted to protect and have the highest level of regulation where we know the large percentage of the users of derivatives are people who cannot be called sophisticated financial players.

Senator CRAPO. That is a good explanation. That helps me understand a little better why the agriculture was so distinct. Nobody is proposing that we move the rest of it into the agriculture-type treatment.

From there, as I am understanding the testimony today, there seems to be some pretty solid consistency on the notion that wash transactions should be prohibited. There is disagreement about whether there are prohibited or not, but there is really no disagreement about the fact that they should be. Is there any disagreement about that?

[No response.]

Senator CRAPO. OK. The same thing could be said about the question as to whether transactions in the exempt category should be subject to the fraud and price manipulation provisions of the Act. Any disagreement of that, with regard to that?

[No response.]

Senator CRAPO. Again, there is disagreement as to whether they already are or are not, but not disagreement as to whether they should be.

From there, it seems to me that we start to break down. I mean, there are some other collateral issues that have been raised about different types of collateralization requirements or reporting and that kind of thing which may result in debate, but it seems to me that there is quite a bit of consensus on those basic points. Does anybody disagree with that?

[No response.]

Senator CRAPO. Now, I have not had a chance to thoroughly review the Act that is being proposed now. The one we debated in March was distinctly different than the one we are talking about today, is it not, Senator Fitzgerald?

Senator FITZGERALD. I do not think so. I have not done a side-by-side comparison—it is? It is completely different?

Senator CRAPO. Yes and no.

Senator FITZGERALD. Depending on which side you are on——

Senator CRAPO. The answers are yes and no. Well, it is different than what I thought it was, and maybe I did not understand it in March as well as I should have, but I understood in March that it was different than what I am hearing today it is, and I guess what I am getting at is if the Act that we are talking about does nothing other than what I have just talked about, namely make it clear that wash trades are not legal and make it clear that the fraud and manipulation provisions are applicable to the exempt

category, then I think we may have the ability to come together on some type of a consensus as to what needs to be done.

I would just say, I am going to have to leave, but Senator Fitzgerald——

Senator FITZGERALD. I guess I think it is also important to have some transparency on these markets, in addition to just banning wash trades, so that people can see the volume and the open interest and just disclosure requirement. It is helpful for the public to know what the prices are. I do not know if anybody else would want to comment on that.

Mr. COFFEE. I would suggest that you cannot define fraud as just boiling down to wash trades. There are other kinds of manipulations, bucket orders. There is a history of various kinds of manipulative games and I think the best prophylactic reform is disclosure, as you were saying.

Mr. PATRIKIS. Price discovery, if you want transparency, depends on the market, the standardization, the volume, that you do not want it to be misleading, you do not want it to destroy the market. That is the issue. It is not clear with these markets that having price discovery mechanism in, if they are not at that point——

Senator CRAPO. Is the question——

Mr. PATRIKIS [continuing]. That that will help the market grow.

Senator CRAPO. Is the question then—is this really the conflict?

Mr. PATRIKIS. I think so.

Senator CRAPO. The conflict, then, is whether the disclosure requirements, the price discovery requirements——

Mr. PATRIKIS. Capital.

Senator CRAPO [continuing]. Capitalization requirements or whatever.

Mr. PATRIKIS. It is the other futures-style regulation raises——

Senator CRAPO. Whether that will impact the market in a negative way and take away the benefit that derivatives now provide to us.

Mr. PATRIKIS. That we will not have an ICE for some other product, that no one will go to the effort and the expense of starting that market up. That is the risk. To me, we want to bring more capital into the market, not set up barriers to bringing more capital into the market.

Senator CRAPO. Mr. Chairman, I apologize. I am going to have to leave, but I am very interested in seeing where we can go from here. At least, if I do not find out that I understand it wrong again as I leave the room, it seems to me that we have found some areas where there is not disagreement and I think maybe I am starting to focus on where the conflict is. Hopefully, from there, we can resolve some of these issues.

Senator FITZGERALD. Thank you. We are going to probably want to wrap this up. I want to thank Senator Crapo for working hard to get his arms around this big issue and I am glad not just people representing Chicago are interested in the commodities futures issues.

I would like to close with one final thought, that I think that the opposition to Senator Feinstein and my bill is wrong-headed, that it is not in the best interest of the people who are opposing it, because I think confidence in the online energy and metals trading

platforms might be restored by allowing for some minimal government regulation. In the last few months, business has been migrating away from this completely unregulated area back to the fully regulated exchanges, and I do not think that Intercontinental Exchange has thought through its best interest on this. I do not think it is in their long-term interest.

This online industry could dry up in the absence of regulations, and I would point out that many people were fearful when we adopted the Securities Act in the 1930's that it would kill capital markets. But, in fact, it gave us the greatest capital formation markets in the world, and that the right level of regulation that provides for, largely, disclosure, can be a great source of reassurance for people who potentially may want to participate in the market.

I would agree that you can suffocate a market by over-regulating it, but I do not think that the Feinstein-Fitzgerald bill comes close to doing that. It would actually help the interest of the online energy trading industry.

With that, I want to thank all of you for your time. It has been a very good discussion. You have all been very patient, waiting through votes and so forth. Thank you all very much for coming.

This meeting is now adjourned.

[Whereupon, at 1:27 p.m., the committee was adjourned.]

APPENDIX

JULY 10, 2002

U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
HEARING ON COMMODITY FUTURES TRADING COMMISSION OVERSIGHT OF MARKETS IN OVER-THE-COUNTER DERIVATIVES
SENATOR TOM HARKIN, CHAIRMAN
JULY 10, 2002

This morning I am pleased to welcome everyone to our Committee for a hearing on regulation of markets in over-the-counter derivatives and the CFTC's oversight role. The main focus of this hearing will be the regulatory treatment of derivatives based on "exempt commodities," such as energy and metals, following passage of the Commodity Futures Modernization Act of 2000. During this hearing, the Committee intends to examine the scope of the CFTC's authority and its exercise of its authority to insure market transparency, prevent and punish fraud and manipulation, and restore confidence in these markets. The impact of OTC derivatives markets reaches well beyond the immediate parties to the transactions. The integrity of these markets and confidence in them are critically important to shareholders, investors, consumers and the broader economy.

The OTC derivatives markets have assumed an increasingly large role in the U.S. economy. A recent *conservative* estimate put the size of the global OTC derivatives market at $111 trillion. The U.S. share of that market is estimated to be at least two-thirds. Derivatives based on "exempt commodities," such as energy and metals, make up a small percentage – probably no more than 2% – of the total OTC derivatives market. However, derivatives play an increasingly important role in energy and metals markets, which are in turn critical to our overall economy.

When the CFMA was enacted in December 2000, one of its primary goals was to insure legal certainty for OTC derivatives. For the most part, the CFMA was based on the recommendations of the President's Working Group on Financial Markets issued in 1999. The President's Working Group recommended that certain transactions involving financial derivatives be excluded from the CFTC's jurisdiction.

The President's Working Group did *not* recommend a similar exclusion for transactions involving energy and metals derivatives.

During development of legislation in the Senate, there was discussion of the issue of oversight of energy and metals derivatives markets, and Sen. Lugar and I both supported, in this Committee, a version of the legislation that was consistent with the recommendations of the President's Working Group, and excluded only financial derivatives – not energy and metals derivatives – from the CFTC's jurisdiction. The bill codified an exemption, with specific safeguards, for certain commodities such as energy and metals.

The final version of the legislation included in the omnibus appropriations bill differed from our Committee bill regarding energy and metals derivatives markets. I supported the CFMA, although I had some concerns about its treatment of energy and metals products, because I thought it had a number of very positive features, and on the whole was a good bill. I still think so. It is important that we not undermine the legal certainty this legislation brought to the OTC derivatives markets. However, if there are unaddressed problems with some types of derivatives that could give a black eye to all OTC derivatives.

Although the CFTC is currently investigating allegations of fraud and manipulation in the western energy markets, some have suggested that the CFTC does not, following passage of CFMA, have sufficient authority to effectively and successfully investigate and punish fraud and manipulation in derivatives markets for exempt commodities - particularly energy and metals. Questions have also been raised about the CFTC's ability to prevent fraud and manipulation in the first place. Today's hearing will focus on these issues, and I hope it will help answer some of these questions.

We also expect to discuss possible legislative solutions to any problems identified in the existing regulatory framework for OTC derivatives based on exempt commodities. Senator Feinstein has proposed legislation to increase transparency in the energy and metals derivatives markets, and to clarify and strengthen the CFTC's authority to investigate and punish fraud and manipulation in those markets. Senator Feinstein is here with us today, and I look forward to hearing her statement.

In addition to the distinguished Senator from California, we have two panels of witnesses here with us today. The first panel consists of Chairman James Newsome and Commissioner Tom Erickson of the CFTC. I am very happy that both Commissioners could be with us today.

Our second panel of witnesses consists of Randall Dodd, director of the Derivatives Study Center and former CFTC economist; John Coffee, Adolph A. Berle Professor of Law, Columbia Law School; Neal Wolkoff, Executive Vice President and Chief Operating Officer, the New York Mercantile Exchange; Ernest T. Patrikis, representing the International Swaps and Derivatives Association; and Richard Green, Chairman of Aquila, Inc., an energy trading company.

I welcome all of the witnesses to the Committee and look forward to our hearing.

Testimony of James E. Newsome, Chairman
of the Commodity Futures Trading Commission
before the U.S. Senate Committee on Agriculture, Nutrition and Forestry

July 10, 2002

Thank you, Chairman Harkin, Ranking Member Lugar, and Members of the Committee for the opportunity to testify before you today. I would like to provide you with updates on several important topics, including the Commission's progress in working with the SEC to permit the trading of security futures and in implementing the important anti-money laundering provisions of the Patriot Act. First, however, I would like to directly address certain issues regarding U.S. energy markets.

As you know, the Commission is an independent federal regulatory agency, whose mission is to oversee the futures and options markets in the United States. We take very seriously our mission to ensure that these platforms provide safe, sound and transparent markets for risk management and price discovery for a variety of commodities, including agricultural, financial, metal and energy products.

The energy markets are among the largest and most dynamic in the United States. Hundreds of billions of dollars in energy products - which would include electricity, natural gas, crude oil, and gasoline - are traded each year in the United States – both on-exchange and in the over-the-counter (OTC) Markets. The Commission regulates the on-exchange futures and options energy markets, which provide significant risk management and price discovery functions for both retail and institutional investors. Energy products are primarily traded on the New York Mercantile Exchange, which is registered with the Commission.

There is also significant trading in energy products in the OTC markets. As a general matter, the Commodity Futures Modernization Act of 2000 (CFMA) provided legal certainty for OTC trading in exempt commodities – such as energy products. In addition, the CFMA promoted the growth of electronic trading systems for these commodities. The level of Commission involvement in the OTC markets was tailored to the nature of the participants and commodities. The OTC markets in energy products are generally restricted to very large institutional investors. The CFMA authorized the Commission to investigate and prosecute fraud and manipulation in exempt commodity markets, with some limited exceptions. EnronOnline operated an electronic trading platform, which accounted for a sizable percentage of the OTC energy product market. It was not registered with the CFTC.

We are all well aware of the tragedies that occurred last fall surrounding the collapse of Enron. For instance, there have been numerous stories in the press regarding allegations of manipulations in energy markets. I would like to take a few minutes today to talk about these issues as they relate to the jurisdiction of the CFTC, and let you know what it is that we are doing to fulfill our obligations and responsibilities in these areas.

Currently, we are in the process of pursuing a comprehensive, detailed investigation of allegations raised by the Enron collapse, and we will aggressively

continue such investigative efforts to detect and deter any illegal conduct in the markets we oversee.

Albert Einstein once said, "If you have seven days to solve a problem, spend six of them defining it." From the beginning of the discussions on these energy issues, my position has been that we need to find the "facts" first, before proposing or supporting a "solution." My position has not changed.

Allegations have been made that Enron and others manipulated the West Coast and California energy markets. These are serious allegations. Not only are they serious, they are jurisdictionally complex, potentially involving multiple regulatory authorities coordinating their differing jurisdictions. We are working actively with other authorities, cooperatively and aggressively, to pursue any and all allegations that are within our jurisdiction.

I have put the full resources of our Commission behind this investigation in order to make the appropriate determinations regarding whether or not illegal activity within our jurisdiction occurred. If indeed that proves to be the case, we will prosecute the wrongdoers to the fullest extent possible. I commit to keep you informed of our progress as we pursue this complex and wide-ranging investigation and I ask for your patience while we do so.

Looking beyond our energy investigations, I am happy to report that trading volumes show that the commodity futures and options markets continue to grow in their importance as providers of unique risk management tools and as a means of price discovery. Last year represented another record year for U.S. futures volume, up 60% over the prior year. Indeed, trading quadrupled over the last ten years. Remarkably, September 11th had no sustained impact on volume, which was already surging by September. In fact, September volume was almost normal, even on the New York exchanges, which I attribute to the foresight, resourcefulness, and tenacity of everyone at the New York Board of Trade, the New York Mercantile Exchange, and the hundreds of firms trading there who got these markets back up and running even before the stock markets resumed trading.

I am also happy to report substantial progress by the Commission in implementing the Commodity Futures Modernization Act. A great deal of rule modernization work was accomplished last year to implement those provisions of the new law regarding exchanges and clearinghouses. But that was only the first step.

Security Futures:

I can now report that the Commission has adopted all final rules, including margin rules, necessary to permit domestic trading in security futures without further delay. I expect that the SEC will act on the margin rules very shortly. This has been a challenging process. Each agency has its own unique oversight tradition, applicable to the very different needs of the capital formation markets and the risk allocation markets under our respective jurisdictions. But I believe that the structure agreed upon, though perhaps not ideal from any single perspective, is fair and workable. I also believe that it faithfully adheres to Congress' intent. I appreciate the guidance and assistance that this Committee

and its staff provided and I am looking forward to completing the foreign participation aspect in the very near future. I hope that you share my great interest in seeing how and by whom these important new risk management products will be utilized.

Intermediaries Study:

Of course, permitting the trading of security futures was only one aspect of the CFMA. The CFMA also mandated a review of rules affecting futures commission merchants and other types of intermediaries that play such important roles in the futures markets. Although the events of last fall changed everyone's priorities for a time, the Commission has completed its study of intermediary rules -- following months of soliciting public input through interviews, written comments, and a public meeting -- and submitted that study to Congress. We will soon host several roundtables on related issues and I look forward to working with this important segment of the futures industry to develop appropriate rule revisions and potential legislative recommendations.

September 11th Responses:

In the wake of September 11th, the Commission and other financial regulators were charged implementing important anti-money-laundering provisions of the Patriot Act. We have worked closely with the Treasury Department, other regulators, and the futures industry to fulfill this national responsibility. The Commission has already approved a rule on customer identification requirements that has been sent to Treasury for its joint approval. We are finalizing another rule on suspicious activity reports from futures commission merchants and introducing brokers, which we plan to share with Treasury later this week.

Implementing relevant provisions of the Patriot Act was just one of the challenges and new responsibilities that faced the Commission in the wake of the attacks. As you know, our New York Regional Office was located on the 37th floor of 1 World Trade Center. Thankfully, all of our employees escaped without major physical injury. Using backup systems and with help from staff of the Chicago Regional Office and D.C. headquarters, we provided ongoing surveillance of the markets in the hours and days immediately following the attack. The Commission worked steadily to fully reestablish its permanent presence in New York City and earlier this year moved back into permanent space in Lower Manhattan from temporary quarters in Jersey City, New Jersey. The Commission and its staff are particularly appreciative and grateful for the assistance of Congress in securing the supplemental funding we needed to recover.

Two of the four largest commodity futures exchanges regulated by the CFTC were also based in Lower Manhattan: the New York Board of Trade and the New York Mercantile Exchange. Both were drastically impacted on September 11th and trading did not resume on either exchange for several days. Other futures exchanges, in Chicago and elsewhere, were impacted by events in New York, particularly by the closing of the stock markets, and experienced temporary interruptions in trading.

But in its preparedness and by its responses to this unprecedented disaster, the futures industry demonstrated foresight, resilience, and determination. Steady leadership,

thoughtful contingency plans, prudent investments in redundant facilities and backup systems, the ingenuity of technical staffs, and the courage and tenacity of everyone in the industry, made possible a remarkably fast and effective resumption of trading, restoring for the U.S. economy rapid access to risk management and price discovery tools uniquely provided by the futures industry. The Commission, in coordination with local authorities, other federal regulators within the President's Working Group on Financial Markets, the Congress, and the White House, strove to assist the industry in restoring operation of these important markets. In order to memorialize the lessons learned and to spark discussion within the industry on how to better prepare for future disasters we hope never to face, the Commission completed a detailed report on both its own and the industry's efforts to recover from the attacks.

Internal Challenges:

As busy as this Commission has been with our efforts to fully implement the CFMA, and with unforeseen challenges like September 11th and Enron, we have also been hard at work transforming the CFTC into what I believe everyone will come to recognize as a more efficient, responsive, and effective oversight regulator that is well structured to properly oversee trading in the many innovative products and platforms that I believe will flourish under the CFMA. On July 1st, we officially replaced the Division of Economic Analysis and the Division of Trading and Markets with the Division of Market Oversight and the Division of Clearing and Intermediary Oversight. We have also added a new Office of the Chief Economist. The Offices of Public Affairs and Legislative and Intergovernmental Affairs have been combined to form the new Office of External Affairs. Each new leadership position is now filled by an experienced professional.

However, we continue to face a serious challenge in attracting and retaining the type of highly skilled and experienced staff needed to operate effectively with our new regulatory mandate under the CFMA. With that mandate, the Commission is moving from the role of a front-line regulator to a more flexible oversight role. Some might believe that, in this new capacity, the agency will need fewer resources than in the past. Just the opposite is true. The CFMA has opened the way for innovation that is creating new financial products and new trading platforms and also permitting the clearing system to respond in kind. I believe we have seen only the beginning of this exciting process.

Although this growth and innovation in the marketplace promises to provide real benefits to market participants and the economy as a whole, it also places increasingly greater demands on the resources of the Commission because our primary responsibilities have not changed. With new exchanges and alternate trading platforms, there is no longer a "template" to follow; rather, oversight must be tailored to fit a variety of markets along a spectrum of regulatory classifications from basic fraud and manipulation protections to full oversight. To continue to fulfill our mission to promote markets that are free from congestion or manipulation and to protect market participants from fraud and abusive practices, we must have staff with the proper training and with solid experience in the markets we oversee.

All too often, however, we lose good people just as they are coming into their own as commodity lawyers, economists, and trading specialists. Our turnover rate is more than twice the federal average. In most, if not all, cases the CFTC's ability to compensate such highly skilled people lags not only far behind that of the private sector, but also well behind that of the other federal financial regulators, where turnover rates are significantly lower. Until recently, we were the only financial regulator still subject to the pay restrictions of Title V. While we are immensely grateful to the House and Senate for working so hard to successfully provide the Commission with a pay parity provision in the farm bill and we hope you will provide funding to fully implement this provision.

I thank you for the opportunity to testify today and will be happy to answer any questions you may have.

Testimony of

Thomas J. Erickson, Commissioner

Commodity Futures Trading Commission

Before

Committee on Agriculture, Nutrition, and Forestry

United States Senate

July 10, 2002

Chairman Harkin, Senator Lugar, distinguished members of the Committee, thank you for this opportunity to testify before you today. I have been asked to comment on three issues: the scope of the existing regulatory authority of the Commodity Futures Trading Commission (CFTC or Commission) over markets in over-the-counter (OTC) derivatives; the need for increased Commission authority to prevent fraud and manipulation; and legislative proposals pending before the Senate that would address any deficiencies.

The CFTC's Role in Oversight of OTC Derivatives

Any discussion of the CFTC's present jurisdiction must begin with an understanding of the effect of the Commodity Futures Modernization Act of 2000 (CFMA)[1] on the regulatory framework previously applied to derivatives markets. Passage of the CFMA in December of 2000 brought sweeping change to the regulation of derivatives in the United States – both on- and off-exchange. Nowhere was the change in the law more dramatic than in its effect on OTC derivatives, more commonly referred to as swaps.

Prior to the amendments of the CFMA, the Commodity Exchange Act (Act)[2] applied equally to all commodity derivative transactions. Many of the CFMA's changes to the Act were based on the recommendations of the President's Working Group on Financial Markets (PWG).[3] The PWG Report recommended that bilateral transactions in financial commodities between

[1] Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

[2] 7 U.S.C. § 1 *et seq.*

[3] Report of the President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (November 1999).

sophisticated counterparties be excluded from the CFTC's jurisdiction for two reasons: first, because most of the market participants were otherwise regulated by at least one of the federal financial regulators;[4] and second, because the financial markets, such as those in interest rates, were too deep and liquid to be readily susceptible to manipulation.[5] The members of the PWG stated that the same case could not be made for physical commodity markets.[6] Accordingly, the PWG did not recommend any change in the oversight of physical commodity market transactions.

The CFMA adopted a variant of the PWG recommendations and created three categories of commodities. Each category defines the CFTC's regulatory interest in derivative instruments, including swaps. Generally, under the CFMA financial commodities are excluded from the CFTC's jurisdiction;[7] agricultural commodities are included in the CFTC's jurisdiction;[8] and all other commodities – including energy and metals – are exempted from the CFTC's jurisdiction.[9] What this means in application is not so simple.

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[4] *Id.* at 16. Federal financial regulators include the Federal Reserve Board of Governors, the Department of the Treasury, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

[5] *Id.*

[6] *Id.* (stating, "Due to the characteristics of markets for non-financial commodities with finite supplies, however, the Working Group is unanimously recommending that the exclusion not be extended to agreements involving such commodities.").

[7] 7 U.S.C. §§ 1a(13) and 2(d).

[8] Agricultural commodities are neither excluded nor exempted under the Act, and thus remain within the exclusive jurisdiction of the CFTC.

[9] 7 U.S.C. §§ 1a(14) and 2(h).

In part, the complexity stems from the fact that the regulatory framework hangs on the distinction between "excluded" and "exempted" commodities. An excluded commodity, transaction, or market indicates that the Commission has no jurisdictional interest. An exempted commodity, transaction, or market, meanwhile, means that the Commission retains a jurisdictional interest, but that the law limits its application.

Ostensibly, under the CFMA, the CFTC retains anti-fraud and anti-manipulation jurisdiction over exempt commodities.[10] However, through other provisions in the law, the vast majority of OTC swap transactions in energy and metal commodities become excluded.[11] As a result, they are not subject to the Commission's fraud or manipulation authorities. Not only do these transactions fall outside the jurisdictional reach of the CFTC, but in most cases, they are beyond the reach of any other federal financial regulator.

The Case For Restoring Fraud and Manipulation Authorities Over Swap Transactions in Exempt Commodities

Thus, we have a gap in the oversight of exempt commodity transactions. And plainly, this gap was not something the PWG intended when it made recommendations in its 1999 report. First, the report stated that exclusion was warranted where most market participants were otherwise overseen as financial institutions by a federal financial regulator. I do not believe that any of the entities currently under scrutiny in the energy markets is overseen as a financial institution by

[10] Section 2(h) of the Act affirmatively retains fraud and manipulation authorities over exempt commodities.

[11] Section 2(g) of the Act excludes from Commission jurisdiction all swaps except those in agricultural commodities. Thus, swaps in exempt commodities are, in fact, excluded from CFTC oversight. In short, the exclusion trumps the exemption. Moreover, Section 2(e) of the Act excludes, among other things, electronic trading facilities engaged in trading swaps – whether through bilateral or multilateral exchange markets. Thus, by dint of the type of trading platform, another exclusion is effected.

any of our federal financial regulators. Second, the PWG concluded that physical commodity markets were more susceptible to manipulation. Allegations of manipulation in energy markets certainly support this conclusion. Third, despite the conclusions of the PWG Report, under the CFMA virtually all OTC transactions in exempt commodities are excluded from the anti-fraud and anti-manipulation provisions of the Act.

The gap creates a conundrum. On the one hand, the Act expects full prosecution of manipulations of exempt commodities in regulated exchange markets. On the other hand, the regulatory regime in place today turns a blind eye to the manipulation of these very same commodities, if effected through OTC derivatives transactions. I cannot believe this was the intended result of the CFMA.

From a practical perspective, the Commission's own experience has yielded some significant results in this area – results that would be difficult, if not impossible, to replicate under current law. For example, the Commission in 1998 reached a settlement with Sumitomo Corporation for the manipulation of global copper prices.[12] The Commission found that the manipulation imposed enormous costs on traders, manufacturers, retailers, and consumers of copper. More recently, the Commission settled with Avista Energy, Inc. for the manipulation of electricity futures.[13] Interestingly, the Commission found that the manipulation created artificial settlement prices in futures contracts and was done to enhance the value of Avista's OTC swap positions.

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[12] *In re Sumitomo Corp.*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,327 (CFTC May 11, 1998) (finding that Sumitomo engaged in a scheme to manipulate the price of copper through actions taken on the London Metals Exchange, which caused artificially high prices in cash and futures markets in copper, including those in the United States, and assessing a $125 million civil monetary penalty).

[13] *In re Avista Energy, Inc., et al.*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,623 (CFTC August 21, 2001) (finding that Avista manipulated the settlement prices of the Palo Verde and California-Oregon-Border

I am skeptical that the Commission could replicate these cases in today's market environment. As the *Avista* settlement underscores, commodity markets – cash, futures and options, and OTC swaps – are increasingly linked. We now know that wash transactions in unregulated swaps occur, and in certain cases send price signals that raise manipulation concerns. Thus, if we are serious about detecting and deterring fraud and manipulation, these authorities must apply to all derivatives transactions.

Derivatives markets bring unquestionable efficiencies to cash commodity markets. The consequent benefits extend not only to market users, but also to consumers. Thus, I believe that if Congress were to restore to the Commission its fraud and manipulation authorities, it must also provide the Commission with the tools to enforce these authorities. Derivatives marketplaces like electronic swap exchanges should adhere to certain, minimal regulatory obligations: among them are transparency, disclosure, and reporting.

- Transparency – The display and dissemination of bids and offers inspire public confidence in the integrity of the market. Participants, no matter how sophisticated, need to know that a price reflects real competitive forces.

- Disclosure – Closed, private markets should make adequate disclosure to their participants regarding the structure and method of operation of the market. The Enron bankruptcy reminds us that markets fail. Independent determinations of

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electricity futures contract in order to increase the company's net gain on certain OTC options positions, whose value was based on the settlement prices at issue).

creditworthiness may not be sufficient when evaluating the health of an exchange market like the one operated by EnronOnline. Perhaps these markets should be separately capitalized.

- Reporting Obligations – When private exchanges operate as financial markets, they should be obligated to register with and report certain essential information to a federal financial regulator. Such basic information might include the operator's risk exposures and trading information that enable ready assessments of trading activity for market and pricing integrity.

Our experience with the futures markets has shown us that measures designed to increase market transparency instill confidence in markets, attract speculative liquidity, and increase market integrity by providing regulators with the means to monitor for fraud and manipulation. I believe application of these principles to derivatives markets generally is sound public policy, prudent business practice, and common sense. Unfortunately, we are presently witnessing some of the best arguments in favor of such changes.

U.S. energy markets are suffering a crisis in confidence. Six months ago we could define the scope of the crisis by the tens of millions of energy consumers in western states who believed the markets had been manipulated. To date, none of our federal regulators have been able to assure them that this was, or was not, the case, and it is not even clear which regulator should be answering the question. More recent revelations of wash sales by numerous commercial market participants have expanded the scope of this crisis – eroding the trust and confidence firms have

in each other. In this environment, liquidity dries up and the market efficiencies created by all derivatives are put at risk. I believe this crisis in confidence is shaking the very foundation of our energy markets. Modest legislation is a good first step toward restoring this lost confidence and returning energy markets to a path of growth and efficiency.

Legislative Solutions

The only legislation that I am aware of pending before the Senate is that introduced last spring by Senator Feinstein, so I will limit my comments to that bill. Generally, the legislation would address the essential concerns I have outlined in my testimony. Moreover, the bill hews more closely to the recommendations of the President's Working Group on OTC derivatives, as well as many of the expressed concerns of this Committee during the consideration of the CFMA. Could it do more? Certainly. Is it the right thing to do? Absolutely.

Ultimately, Senator Feinstein's bill is pragmatic. It recognizes the benefits of market innovation by preserving the long-sought legal certainty for swaps – they remain for the most part "exempt" from CFTC jurisdiction. At the same time, however, the bill ensures that all derivatives transactions are subject to the Commission's fraud and manipulation authorities. It would not require the registration of swap counterparties, but would require that they maintain books and records of transactions – something that should be routine practice in the industry. Finally, the legislation recognizes that all exchange markets serve price discovery and hedging purposes by imposing modest transparency, disclosure, and reporting obligations.

It is interesting to note that if EnronOnline were to have been operated by a bank, its risk exposures would have been reported to the banking regulators. Moreover, those regulators would have the authority to impose capital requirements on the market. The government, I believe, must be consistent in its expectations. Senator Feinstein's bill embraces competitive markets in the context of consistent government standards. Enron and companies like Enron should have every right to establish markets and compete with banks, broker-dealers, and exchanges for market share. But if the right policy answer is that markets should be overseen, then all markets should be accountable to a federal financial regulator.

Conclusion

Consumers are the ultimate beneficiaries of properly functioning derivatives markets, whether those markets are private – like EnronOnline – or public – like the New York Mercantile Exchange. By the same token, consumers are the ultimate victims when markets are manipulated, or otherwise affected by unlawful behavior.

Whether there is ever anything found in current investigations of energy markets is irrelevant. We have a hole in our regulatory regime that allows for fraud and manipulation to operate free from sanction. We have markets experiencing a crisis in confidence. Modest legislation amending the commodities laws is appropriate in my view to restore confidence and build integrity.

Thank you for this opportunity to appear before you. I look forward to your questions.

CFTC Oversight of Energy Derivatives

Commissioner Thomas J. Erickson
Commodity Futures Trading Commission

Keystone Dialogue on Financial Trading Around Energy Markets
Washington, DC (June 24, 2002)

Overview

- The idea that all energy derivatives markets are subject to federal oversight is an illusion.
- The Commodity Futures Modernization Act of 2000 permits these markets to choose their level of regulation – and avail themselves of gaps in the regulatory structure.
- These gaps can only be closed through legislation by Congress.

Derivatives Regulation of Yore

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 (CEA Sec. 2(a))

Included in the CFTC's Jurisdiction *

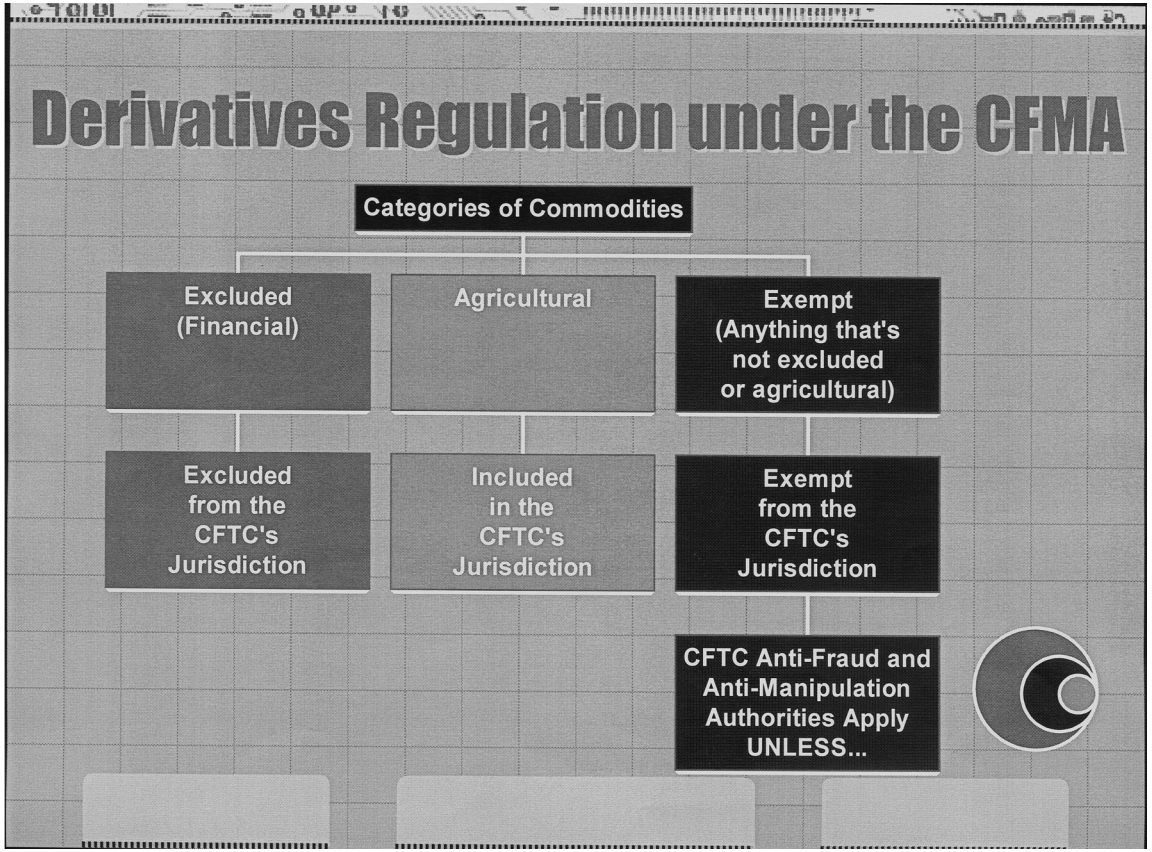
* Does not include statutory exclusions and Commission actions not relevant to this dialogue.

Derivatives Regulation pre-CFMA

Included in the CFTC's Jurisdiction UNLESS... *

- Exempt Swap Agreement Under Part 35 (1993)
  - CFTC Anti-Fraud and Anti-Manipulation Authorities Apply
- Exempt Energy Contract Under Final Order (1993)
  - CFTC Anti-Manipulation Authority Applies

* Does not include statutory exclusions and Commission actions not relevant to this dialogue.


Derivatives Regulation under the CFMA
Categories of Commodities
Excluded (Financial)
Agricultural
Exempt (Anything that's not excluded or agricultural)
Excluded from the CFTC's Jurisdiction
Included in the CFTC's Jurisdiction
Exempt from the CFTC's Jurisdiction
CFTC Anti-Fraud and Anti-Manipulation Authorities Apply UNLESS...

The Exclusion of Exempt Markets

How Markets in Exempt Commodities become Excluded from the CFTC's Jurisdiction

Section 2(g): Swaps in Exempt Commodities	Section 2(e): Electronic Trading Facilities
Excluded from the CFTC's Jurisdiction	Excluded from the CFTC's Jurisdiction
So Anti-Fraud and Anti-Manipulation Authorities Do NOT Apply	So Anti-Fraud and Anti-Manipulation Authorities Do NOT Apply

Building Blocks for Market Integrity

- Transparency:
  - Open and public markets with bids and offers publicly displayed and widely disseminated inspire public confidence in the integrity of the market.
- Disclosure:
  - Even closed, private markets should make adequate disclosure to their participants regarding the structure and method of operation of the market.
- Reporting:
  - Markets should report certain essential information to a federal financial regulator, *e.g.*, risk exposure, bids and offers, trading information.

Statement of

Randall Dodd

Director of the Derivatives Study Center

Before the

Senate Committee on Agriculture, Nutrition and Forestry

Hearing on the OTC Derivatives Market and
the Regulatory Authority of the CFTC

July 10, 2002

It is an honor to be invited here to offer my insights on the nature of derivatives markets and what should be their proper regulatory framework. In doing so, I hope to add value to this important public policy debate.

The present interest in derivatives market was brought by about a series of problems that include the disruptions in energy markets in the west, the collapse of Enron and the subsequent series of corporate calamities. All these difficulties have brought to the public's attention many serious problems with our financial system. In addressing this public concern, we are faced with the dauntingly large and growing number of these problems that poses a genuine problem in conceptualizing the cause and the cure. There are problems with executives, problems with auditors, problems with the Board of Directors, problems with accounting officers, problems with stock analysts and problems with journalists covering the market news. And these are just the bad apples. There are also bad "non-apples" such as inadequate accounting rules, inadequate financial reporting rules, off-shore tax havens, the use of special purpose entities and vehicles, wash trades, sharp trading practices, fraudulent trading practices, the manipulation of energy prices and the misuse of derivatives. I do not think these myriad problems have any one single cause or cure. They may best be described as Yogi Berra did of the Yankee's loss in the 1960 World Series: "We made too many wrong mistakes."

I will focus on the role of derivatives because they played a major part in these problems, and I believe that it will not be possible to solve auditing and financial reporting problems without more transparent derivative markets and I believe we cannot expect to

maintain safe, sound and orderly trading conditions in our nation's commodity and financial markets unless derivatives markets play by the same basic rules as the banking, securities and insurance sectors.

Let me explain and justify those claims.

Derivatives – and I used the term to refer to the large class of financial instruments that includes futures, forwards, options, swaps – are traded either on a well-regulated exchanges such as the Chicago Board of Trade or in over-the-counter (OTC) markets in an unregulated environment. Since the first OTC interest rate swap was traded 20 years ago, the OTC derivatives market has grown to become one of the pillars of finance along with banking, securities and insurance. The BIS reports (conservatively) that the amount of outstanding OTC derivatives is $111 trillion worldwide -- about 2/3rds of which is in the United States. The trading volume in exchange traded futures and options is $445 trillion (and that excludes large classes of exchange traded derivatives such as commodities and single stock options), while the open interest amounts 24.8 trillion. Based on these figures, derivatives not only rival but exceed the size and trading volume or securities markets and the outstanding amount of bank loans and mortgages. Derivatives are definitely a very important part of our financial system and economy as a whole.

Their growth and importance comes from the two important economic functions that they serve: price discovery and risk shifting (also referred to as hedging or risk management). A proper regulatory environment should encourage these activities. Growth in the exchange-traded derivatives markets is a testimony to this. Unfortunately, their growth also comes from unproductive, if not nefarious, uses such as the distortion of financial reports to hide debt, the fabrication of income, tax avoidance and outflanking prudential regulation of securities, banking and insurance activities. A proper regulatory environment should sharply discourage these activities.

Derivatives play an especially important role in the energy and metals markets. Energy use in the U.S. economy is about $600 billion year, and the number and amount of transactions needed to produce, transport and distribute that 98.5 quadrillion BTUs of energy is many times that $600 billion. The exact amount of derivatives in these markets is unknown because there are no reporting requirements or voluntary efforts. However, in my Special Policy Brief of February 2002 entitled "The Bigger They Come, The Harder They Fail: Enron's Lesson for Deregulation," I estimated the dollar value of Enron's derivatives book for year end 2000, and found that it included $758 billion in energy derivatives and another $16 billion in interest rate and foreign exchange derivatives. To this should be added the trading of Duke, Dynegy, Williams, El Paso and the others. The sum is mostly likely to be more than ten-fold the amount of final energy use. In this large and crucial sector, it is imperative that these markets work in a safe, sound and efficiently.

In order that derivatives markets yield the economic benefits of price discovery and risk management, and are devoid of the social costs from unproductive uses, the following market conditions are needed.

1) Prices, and other key market information, are observable to everyone, i.e. markets are transparent;
2) prices are regarded with a high level of integrity (not viewed as tainted by fraud or manipulation;
3) transactions in derivatives instruments are conducted in an orderly manner (markets should not freeze or become illiquid, and price movements should not be excessive); and
4) the derivatives transactions are managed with sound credit practices.

Let me briefly elaborate in order to more thoroughly explain each of these facets. Everyone needs to observe market prices – bid, offer and execution price – in order that each can buy at the lowest and sell at the highest possible available price. It is an inefficient market where participants are paying too much or receiving too little.

In order to protect the integrity of prices, the markets must not be affected by fraud or manipulation. The reason why is stated beautifully in earlier versions of the Commodity Exchange Act: derivatives prices are "affected with a national public interest. The prices in such transactions are generally quoted and disseminated throughout the United States... for determining the prices to producer and consumer of commodities and the products and by-products thereof and to facilitate the movements thereof in interstate commerce."

Derivatives trading should be orderly. These markets are linked to other markets throughout the economy, and so disruptions occurring in one can be transmitted to the others. Liquidity is a crucial feature of a well organized market, while "freezing" and illiquidity and excessive price movements are not.

Derivatives are highly leveraged transactions that involve large degrees of price exposure. This entails the great credit risks, or the risk that the other party will not fulfill their obligations. In order to minimize this risk of contract failure, and the systemic risk that failure is transmitted from counterparty to counterparty, the capital and collateral must be well managed. Otherwise, failure threatens to cause losses and bankruptcy throughout the economy, and the derivatives market faces a loss of confidence and ceases to yield the beneficial services of price discovery and risk shifting.

Yet these conditions that are needed for efficient and beneficial markets are not being met in the actual market practices of OTC derivatives trading. If markets do not produce proper trading practices on their own, then it is in the public interest for rules and regulation to help establish better practices.

The appropriate level of regulation for OTC derivatives market should have the following three elements:

1) registration and reporting requirements;

2) capital requirements for institutions and collateral requirements for transactions; and
3) orderly market trading rules.

Again, allow me to briefly elaborate.

Registration requirements help prevent fraud on the market by ensuring that individuals involved with customers, end-users and other dealers are competent and do not have criminal records for fraud. If someone is convicted of securities fraud they are barred from securities brokering for life. Yet they can go to work for an unregistered dealer such as Dynegy the next day. Registration that is conditional upon the successful performance on competency exams assures that individuals can be help accountable for their actions.

Reporting requirements make markets more transparent. It gives all market participants equal access to prices and other key market information, and it gives to regulators the capability to observe markets in order to detect problems before they become a crisis.

All OTC derivatives transactions should be adequately collateralized. Enron's failure exposed several bad industry practices, and these should be corrected. The current market practice, in so far there is one, is dangerous. It requires a firm to become "super-margined" if its credit rating drops, and thus initiates a large increase in the need for collateral just at the time the firm is experiencing problems with inadequate capital. This amounts to a *crisis accelerator.* Exchange-traded derivatives have well managed collateral, called margin, and that is a major reason why the flight to quality following Enron's failure lead to the NYMEX. If a well regulated market had not been there to act as a safe harbor, the consequences to the market would have been greater.

Derivatives dealers should have adequate capital. Dealers who are banks or securities broker-dealers do face capital requirements – although as banks and broker-dealers and not as derivatives dealers per se, but entities such as Enron who were major dealers in energy, weather, and credit derivatives amongst others do not face any capital requirements. Capital is important because it serves as a buffer to dampen losses at the dealer from becoming defaults and losses at the dealer's trading counterparties and in turn their creditors and trading counterparties and customers.

Oblige OTC derivatives dealers to act as market makers. They capture the advantages of their privileged position in the market, so they should bear the responsibility – like dealers in U.S. government securities (the most efficient and highly regarded OTC market in the world) – of ensuring market liquidity by maintaining bid-ask prices continuously through trading hours. These markets should also be subject to rules regarding position limits and price movement limits like securities, options and futures exchanges. Lastly, OTC markets should be encouraged to employ clearing houses in order to increase the efficiency of the clearing and settlements process and to decrease the threat of systemic risk.

These rules are not burdensome. First, reporting is all but free of cost. Merely *cc*: the regulatory or supervisory authority in the process of confirming trades. Second, these rules are basically the same as those that apply to banking, securities and insurance – the other pillars of the US financial system. If they prosper while operating under these rules, then derivatives market will too.

Together, these three rules will provide a solid foundation for a remedy to such recent problems as:

- Manipulation
- Wash trades
- Distortion of balance sheet and other aspects of financial reports
- Disrupt trading
- Hampering the work of auditors to determine what is actually going on
- Creating contagion or the transmission of market disruptions to other firms, industries, and economies and to their investors and employees and creditors.

These few prudential market rules will amount to a fundamental improvement in drawing the virtues from these markets while protecting against their misuse. This will restore investor confidence in the derivatives as well as securities markets and the overall economy.

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SPECIAL POLICY BRIEF

The Bigger They Come, The Harder They Fail Enron's Lesson For Deregulation

Randall Dodd
Derivatives Study Center
February 7, 2002

Based on data from Enron's last annual report, the Derivatives Study Center calculates that the amount of derivatives contracts on Enron's books at the end of 2000 was $758 billion in notional value. It is likely that this figure grew by another $100 billion before Enron's trading ceased about 11 months later.

This represents a significantly large amount of trading and dealing in derivatives, and the notional value of Enron's derivatives book compares in size to all but the largest derivatives dealers in the banking and securities sectors.

The fact that Enron had amassed such an enormous quantity of derivatives on their books means that Enron had become a major financial institution and played a significant role in the overall U.S. economy. In order to accumulate a portfolio of that magnitude, Enron had to trade with a large number of firms in many sectors of the economy.[1] The size also suggests that Enron Online and Enron's other derivatives market making likely resulted in at least some degree of price discovery.

Implications.

The most important implication of Enron's enormous derivatives dealing activities is that Enron acted as a major financial institution in the U.S. economy, but was not subject to the safety, soundness and transparency rules that apply to banks, securities brokers and dealers, futures brokers, insurance companies and pension funds. Since Enron was not regulated as a financial institution, it faced no capital requirements; specifically, it was subject to neither a minimum capital requirement nor a requirement that its derivatives and other financial activities

[1]) Data indicates that dealers in commodity linked derivatives trade proportionally more with end-users and other non-dealers than dealers in financial derivatives.

be separately capitalized. Enron was not required to register as a financial institution, and its traders were not required to be licensed to trade OTC (over-the-counter) derivatives. In other financial markets, securities and futures brokers are required to pass exams and register as brokers. Enron was not subject to reporting requirements like regulated financial institutions, and this is a major reason why so little is known about its trading activities and the derivatives markets in which it was operating.

The OTC derivatives markets in which Enron acted as a dealer were entirely unregulated and lacked a public regulatory authority with the capacity to detect potentially debilitating loses among trading firms, detect and deter manipulation or fraud on the market, and to create more transparent markets by requiring the dissemination of key market information.

In short, these numbers show that Enron was an unregulated financial institution engaging in a tremendous volume of unregulated derivatives transactions.

Notional Value of Derivatives

Natural Gas	$152,306,859,676
Crude and other liquids	266,925,868,152
Electricity	338,307,115,555
Metals, coal, pulp, paper	-
Bandwidth	-
Interest rate	8,709,000,000
Foreign currency	544,000,000
Equity	6,766,000,000
Total	$773,558,843,383

Enron. Financial Report, 2000. DSC calculations.
- no estimates made for these contracts due to lack of price information

Comparison of size.

One of the problems with expressing the size of a derivatives dealer's trading book is that the numbers are so large that it is easy to lose sense of their enormity. Once figures reach the billions of dollars, then the hundreds of billions of dollars and then the trillions of dollars, they enter a realm so far beyond the value of people's incomes, homes and even the rare lottery jackpots that it becomes hard to communicate their importance. In order to provide some perspective, consider the following comparisons to the size of the total U.S. economy as well as the derivative books of other major financial institutions.

The size of the total U.S. economy, as measured by the gross domestic product (all the final goods and services produced within the U.S.) reached $10 trillion or $10,000 billion, for the

first time at the end of 2000. By this yardstick, the notional value of Enron's derivatives book was 7.8% the size of the total U.S economy.

Another point of comparison is the size of major U.S. corporations. The Microsoft Corporation is presently valued at $337.5 billion – about half the size of Enron's derivatives book. General Electrics is valued at $365.8 billion – again about half the size of Enron's book.

Perhaps the most direct comparison should be with other derivatives dealers. There are a couple of good sources of data to help in this. The Treasury Department's Office of Comptroller of the Currency (OCC) requires major U.S. banks to report some aggregate figures on the size of their derivatives holdings. The OCC's quarterly derivatives report for the period ending in December 2000, shows that Enron's derivatives book would have ranked as the seventh largest amongst the largest U.S. banks and holding companies. While definitely smaller that Chase, Morgan Guarantee (J.P. Morgan), Bank of America and Citicorp, Enron was larger than Wells Fargo, the Bank of New York and Fleet National.

Enron can also be compared with major Wall Street securities firms. In this case the data come from figures provided by Paul Spraug's Swaps Monitor (www.swapsmonitor.com). While top securities broker-dealers like Goldman Sachs, Merrill Lynch and Morgan Stanley are in a league of their own, with derivatives books ranging in size from $4 trillion to $6 trillion, Enron ranks alongside Bear Sterns, Berkshire Hathaway and AIG. Based on commodity derivatives alone, Enron's volume of transactions exceeded that of all of the major securities firms that reported their commodity contracts separately.

Enron is certainly comparable to other commodity derivatives dealers. These financial institutions are referred to as commodity dealers because they are not – that is, not at all – registered or regulated as either a bank, securities broker or dealer, futures broker or any other financial institution. These commodity dealers are unregulated financial institutions operating in an unregulated OTC derivatives markets.

As a commodity derivatives dealers with an enormous derivatives book, Enron was not along. Data for this comparison also comes from Swaps Monitor. Their estimates for major OTC commodity derivatives dealers show that El Paso Energy had $576 billion in OTC derivatives on their books while Duke Energy had $390 billion and Williams Companies had $273 billion. It showed that Enron had $201 billion in outstanding OTC derivatives in gas, electricity and oil. According to these figures Enron was the fourth largest amongst commodity derivatives dealers. However using the $758 billion estimate from the Derivatives Study Center, Enron was the largest of these OTC dealers.

The differences between the estimates from Swaps Monitor and the Derivatives Study Center are based on three factors: 1) Swaps Monitor excludes all but gas, electricity and oil and other liquids; 2) Swaps Monitor does not treat the commitments for future sales as forwards (without that adjustment the DSC figure is $568 billion); and Swaps Monitor converts the Btue units directly to dollars using the gas price for Btues.[2] Their method is valid and simpler to calculate, but the DSC method does not rest on the assumption that the Btu content in the various energy sources is arbitraged out across commodity prices. The DSC approach allows, for example, the price of Btues from electricity to exceed the price of Btues from crude oil or gas.

[2]) Based on telephone interview with Swaps Monitor staff.

That is why DSC figures for gas differ very little from Swaps Monitors figures on the notional value of gas based derivatives, and the difference is due largely to estimates of the value of electricity and oil based contracts.

Methodology.

The DSC estimated the size of Enron's derivative book using the following methodology. The basic facts were taken from Enron's last annual report filed for the year ending December 31, 2000. In the footnotes to that report, Enron stated the notional principle of its derivatives trading. Most of the numbers were expressed in terms of TBtues, or trillion BTU equivalents. DSC used standard measures for converting BTUs into physical commodity units such as cubic feet for gas, barrels of crude oil, and megawatt hours for electricity. Once the numbers were converted in these units, then a price per unit at that time (end of 2000) was applied to calculate the dollar amount of notional principal. The prices per unit were obtained from a Swaps Monitor report on commodity derivatives dealers published in 2001.

Before proceeding further, a few issues regarding the methodology and numbers used in the estimates should be addressed. First, the basis for the estimates are numbers reported by Enron, and the veracity of anything reported by Enron is now under suspicion. However, there are no other alternative numbers because of the non-transparent nature of these markets and the lack of reporting requirements by OTC derivatives dealers. Second, the figures reported by Enron for crude and other liquids were treated entirely as though they represented pure crude oil. This yields a conservative estimate of the notional principal because the price of crude oil is lower than that for its distillates.

Derivatives and Enron's Failure.

Derivatives played two roles in Enron's failure: first as fraud and then as tragedy.

The catalyst for Enron's collapse starts from the heavy losses they suffered on real, physical investment in such assets as an electrical power plant in India, a water treatment plant in England, a steel mill in Arkansas and fiberoptic broadband capacity across the U.S. They also lost money, often associated with these assets, by investing in ventures designed to create new centralized markets that would dovetail with their wholesale and derivatives trading activities. For example they tried to create such markets in steel, coal, wood pulp and broadband capacity. When these investments turned bad, Enron turned to creative accounting. They hid debt and moved loses off the books of the parent Enron Corporation and into a web of partnerships. Then they used these partnerships to fabricate income that was reported by the parent Enron.

Enron used derivatives extensively in the creation of these partnerships and then again in the effort to hide debt and loses while fabricating income.[3] Derivatives were used to capitalize the partnerships and to guarantee them a positive rate of profit. Derivatives were also used to generate income from the partnerships for the parent Enron Corporation.

Eventually, Enron's loses became so large that they had to be reported publicly as a $1.2 billion charge against equity. This shocking news attracted greater scrutiny to Enron and its practices. Two top executives left, the SEC announced that it was looking into Enron's reporting

[3]) See the letter written by Enron employee Sharron Watkins explaining some of these transactions.

practices, Enron restated income for four prior years to show a $600 million reduction in previously reported earnings and then the news got really bad. Other energy companies and derivatives traders began to lose confidence in Enron as a derivatives counterparty. Enron's trading partners announced that they would either no longer trade with Enron or they would enter into only short-term transactions while they kept a close watch on the situation.

The next blow fell when Enron's credit rating was downgraded. This required Enron to post "super margin" as a performance bond on their derivatives positions with derivatives counterparties. The implication was Enron had to come up with a substantial amount of fresh capital at a time that it was already in trouble for having inadequate capital.

The loss of both trust and investment grade credit rating caused Enron's trading volume to evaporate. Without trading volume, Enron could not earn their bid-ask spread as dealer for Enron Online and other derivatives markets, and without the bid-ask times volume there was no longer the enormous trading profits earned in the previous years. In the end, the bad investment decisions and fraudulent practices destroyed their previously profitable derivatives dealing activities.

Legislative Remedies for Derivatives Markets.

The following set of prudential financial market regulations would make OTC derivatives markets more safe, sound and transparent. They are similar to regulations that apply to other sectors of the financial system, such as banking, securities and futures trading, and they should be applied to all OTC derivatives dealers and derivatives transactions in order to improve safety and soundness and to maintain regulatory parity.

First, establish capital requirements and margin (collateral) requirements. Capital requirements are critical to prevent the problems at one firm from becoming problems at another firm; and they prevent short-term problems at a dealer from causing the market to freeze-up or meltdown. Margin (collateral) requirements do the same for each transaction. The current market practice, in so far there is one, is dangerous. It requires a firm to become "super-margined" if its credit rating drops, and thus initiates a large increase in the need for margin (collateral) just at the time the firm is experiencing problems with inadequate capital. This amounts to a *crisis accelerator.*

Second, establish registration and reporting requirements. All brokers, dealers and other non-end-users of OTC derivatives should be licensed and registered. This is the approach used for securities markets, banking, insurance and exchange-traded derivatives, and it should apply to OTC derivatives markets as well. Reporting requirements will make the markets transparent for the first time, and will give regulators the capability to observe markets to detect problems before they become a crisis.

Third, establish obligations for OTC derivatives dealers to act as market makers. They capture the advantages of their position in the market, and like dealers in U.S. government securities (the most efficient and highly regarded OTC market in the world) they should be obliged to act as market makers throughout the trading day. This will ensure market liquidity was they must maintain bid-ask prices continuously through trading hours.

DERIVATIVES STUDY CENTER

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SPECIAL POLICY BRIEF

Enron: Derivatives and the Damage Done

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Executive Summary:

- The collapse of Enron caused substantial damage to the overall U.S. financial system, the energy sector and a long list of firms and individuals. These facts are in contrast to statements that the economy was not effected and that "*the lights stayed on.*"

- Loss of confidence and the rise of doubts about the integrity of information about U.S. financial markets. This is especially threatening given that in 2001 the U.S. benefited from $1,024 billion inflows of foreign investment and a net inflow of $443 billion after accounting for U.S. investment abroad.

- The energy sector took a beating in the wake of Enron's failure. The sector has lost a large amount of market capitalization since Enron hit the front page on October 16th, and this will impair their ability to raise capital to finance new investment in energy production for the foreseeable future. A sample of 18 large gas and electric companies lost $64.4 billion in market capitalization in the past year, and most of it -- $38 billion – since October 16th.

- Although the damages to the economy as a whole are greater than the sum of the particular losses by creditors, employees and trading partners to Enron, the list of itemized losses from the largest bankruptcy in U.S. history is long and large. Insurance companies lost $1.75 billion, pension funds lost $1.3 billion, banks and securities firms lost $6.7 billion, other energy companies lost $1.2 billion and employees lost an estimated $1.2 billion in retirement funds.

- Derivatives played an important and two-fold role in the collapse of Enron. Regulatory changes will be needed to make OTC derivatives markets more safe and sound and make trading more transparent. Capital requirements on derivatives dealers and collateral requirements on transactions will make this market more stable and less vulnerable to collapse. Registration and reporting requirements will make the market more transparent and less susceptible to fraud.

Introduction

The sensational rise of Enron was the story of a rapidly expanding an energy supply business through debt financed mergers and acquisitions. It was also the story of bringing new levels of financial sophistication into commodity markets, especially the newly deregulated markets for gas and electricity, and forming new derivatives markets for commodities where none previously existed. The wealth it generated enriched dozens of individuals, the largess it doled out helped fund the fine arts and the campaign contributions it put to use made it one of the most politically influential. The meteoric fall of Enron was also many stories. One was the colossal size of Enron – once one of the largest U.S. corporations whose market capitalization hit $90 billion, and later the largest bankruptcy in U.S. history. One was the spectacular rise of Enron the derivatives that created an electronic trading facility called Enron Online and amassed a derivatives book of $758 billion by the end of 2000 before their customers and fellow derivatives dealers withdrew their business and left Enron and their hi-tech trading platform with no one to trade against. Yet another story was the outrageous behavior of its executives, board of directors and auditors who have all contributed to making the failure of Enron a major economic as well as a political event.

In the wake of this enormous failure, Congress has convened a series of hearing in order to better understand what went wrong and why. The media has scrutinized Enron's investment strategies and political maneuverings, and is investigating some of its suspicious financial transactions. Now the public discussion is shifting towards the less exciting, but more important task of analyzing how the U.S. regulatory structure failed to detect or deter the problem.

This Special Policy Brief is designed to clarify two important points that are emerging in the public policy debate. The first point is that Enron's failure and its impact on the economy is of sufficient magnitude that it be considered of national public interest. The second point is that unregulated OTC derivatives played an important role in the collapse of Enron.

Lobbyists for Wall Street firms are already making their rounds on Capitol Hill and to the Bush Administration, and meanwhile their public relations counterparts are making their pitches to the media. They are claiming that the Enron bankruptcy was not a national problem, and that it does not justify a more prudential regulatory approach towards financial markets. They are saying that the Enron collapse was not a problem of national importance because after all, *"the lights did not go out."*[1]

That is not a serious standard, and is worth identifying the irony in the fact that the failure of the Enron Online electronic trading platform was described in similar terms when the screens went blank as Enron Online went offline.[2]

The following section of this Special Policy Brief, entitled "The Damage Done," provides ample evidence to show that the harm to the economy is large and that the damages impacts firms and individuals far beyond those who were immediately involved with Enron.

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[1]) This phrase was repeated again and again by Peter Gaw of ABN Amro, Stacey Carey of ISDA, Sen. Frank Murkowski, Congressman Joe Barton (R-TX), David Owens, of the Edison Electric Institute, and an unsigned editorial in the Financial Times of London.

[2]) "When Enron Online went offline, we instantly went, 'Whoa, were is everyone?' said one traded as the Electric Reliability Council of Texas. Electric Power Daily – November 29, 2002.

The section of this policy brief following that, entitled "The Role of Derivatives in Enron's Collapse," addresses the second point in the public policy debate. It seeks to answer to question, what was the role of derivatives, and the lack of a regulation of the derivatives markets, in the collapse of Enron?

The Damage Done

The failure of the unregulated derivatives dealer Enron has led to the largest bankruptcy in U.S. history. The damages from the collapse of this large financial institution are wide and deep. It has harmed the reputation of U.S. financial markets, it has caused collateral damage to the value of corporations in the energy sector and it has directly lead to loses by a long list of creditors.

Some of the unsound and non-transparent practices and structures of derivatives markets have been exposed by the demise of its derivatives trading operation. The disclosure of the corporation's machinations to hide debt and losses through a veil of partnerships and derivatives transactions offended even the most cynical and cast a pale of distrust on U.S. financial markets by even the most trusting. The result has been to impugn the reputation of the U.S. financial system, otherwise regarded at the best in the world, and thereby threaten to raise to cost of capital to this great capital importing economy.

This concern was well expressed by former Federal Reserve Chair Paul Volcker before the Senate Banking Committee.

> *"Enron is not the only symptom." "We have had too many restatement of earnings, too many doubts about pro forma earnings, too many sudden charges of billions of dollars to good will (and) too many perceived auditing failures accompanying bankruptcies to feel comfortable."*

Portents of the ongoing effects of this are well expressed by Milton Ezrati of Lord Abbett & Co.l which has $42 billion under management.

> *"This accounting cloud is going to hang over the market for a while."*

It is hard to measure this impact of the fall of the 50th largest corporation because of the economy has experience also the effects of the recent recession, the terrorist attacks on September 11th, the subsequent commencement of war and the fact that Enron did not fall all at once. However, one broad measure is the rise in Baa investment grade corporate bond yields above that on Treasury notes. That credit spread has risen 30 basis points since October 16th when Enron reported a large charge-off against shareholder equity – thus bringing some of the hidden losses from its 3000 partnerships back onto the balance sheet.[3] The corporate bond market is key source of funding for new capital investment in the economy, and so higher capital costs – in so far that it can be attributed to an Enron-effect on investor confidence – surely represents damage to the overall economy.

The importance of the reputation of U.S. financial markets should not be underestimated. Former U.S. Ambassador to France and a voice of enlightened self-interest from Wall Street,

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[3]) Data from the Federal Reserve Board. Comparison made for period from July 3, 2001 to October 15th, and then afterwards.

investment banker Felix Rohatyn recently wrote[4] that "integrity must be maintained... to maintain the flow of foreign investment." He went on to point out that 15% or $2 trillions of shared traded on the NYSE and NASDAQ were foreign owned, and then concluded, "The last thing we should tolerate is a loss of confidence in our capital markets."

In 2000, the U.S. ran a deficit in its current account on trade in goods and services and payments of income on capital that reached $444 billion. That deficit was financed with an equally large net inflow of capital from foreign investors. That net inflow of foreign capital, amounting to 4.5% of the GDP of the U.S., underestimates the actual inflow of foreign investment into U.S. markets. The gross inflow was $1,024 billion, or 10.4% of GDP, and it functioned to offset an outflow of investment from the U.S. of $581 billion. Not only will foreign investors be discouraged by a loss of confidence in the integrity of U.S. financial reporting and corporate investment practices, but so will U.S. investors. Thus the ability to successfully finance the U.S. current account deficit with net capital inflows will be harmed by both the willingness of foreigners to invest in U.S. capital markets as well as the interest in U.S. investors of increasing their investments abroad. For example, a reduction of foreign investment inflows by 15% and a similar 15% in U.S. investment abroad would reduce the net inflow by $240.75 billion or by more than 54%!

The costs of Enron's collapse on investor confidence in market integrity focused especially on the volatility of stock prices in the energy sector. Along with Enron's failure came lower share prices for stocks in the energy sector. Energy analyst Fadel Gheit, of Fahnestock & Co. in New York, put it dramatically, "Enron is the third World Trade Center. This is the collateral damage."

The fall in stock prices following the break of the first major news of Enron's reporting problems on October 16th wiped out tens of billions of dollars of market capitalization in the energy sector. Gas corporations suffered along with electricity corporations. The result was that the stock prices and market capitalization were reduced by more than half over the preceding year, and most of that loss occurred in the recent months following the Enron "event."

The consequent of this hit to the energy will likely be a reduction in investment in additional energy supply capacity for years to come. Energy production is very capital intensive, and the higher capital costs associated with such a decline in market valuation will discourage a great of potential new investment.

The damage to the whole economy is larger than the sum of these particular losses. One reason for this is due to the Enron-effect on the stock market. This effect can be shown by the decline in market value of share prices for other major energy firms. The Derivatives Study Center collected information on market capitalization[5] of Enron and 15 other major energy companies in the U.S. and looked at how it has changed over the past year, after the terrorist attacks on September 11 and then after the initial disclosure of Enron's problems on October 16.

The three gas companies comprise 28.8% of the market capitalization in their sector while the 12 electricity companies make up 26% of the market capitalization in theirs. Thus these large firms represent a considerable share of their total sectors.

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[4]) New York Review of Books, February 28, 2002.
[5]) Market capitalization is the market price of a share of stock times the number of outstanding shares.

Starting from February 26, 2001 (a year from the date when we began collecting this information), these 15 corporations lost $36.3 billion in market value in the six and one-half months prior to September 11th. They lost another $7 billion following the terrorist attacks and before October 16th. In the four months from October 16th until February 25, 2002, those firms lost another $42.5 billion in market capitalization. Enron itself lost $24.8 billion in market capitalization during that fateful period. Those 16 firms together lost $93.3 billion in market value. (The figures are shown below in a table in Appendix I.)

Note that not all firms lost value over the entire year or in each time segment. For example, five of the electricity companies and one of the gas companies actually gained in market value in the month immediately following September 11th. All the gas companies lost money following October 16th while three electricity companies gained (one was First Energy which managed to increase market capitalization during each of the time periods).

These losses are not just symbolic, but rather have the very real effect of determining the cost of capital to these enterprises. When share prices decline and the cost of capital rises, then the energy firms find it more difficult if not infeasible to raise new capital in order to invest in additional energy supplies. Thus these figures suggest that the U.S. economy will suffer from a shortfall in investment in energy into the near future.

The widespread impact of Enron's collapse on the macroeconomy and the energy industry should not distract from identifying the large losses to particular firms and individuals.

By collecting various reports from the media, the Derivatives Study Center has compiled a partial list of the reported losses. Of these, pension funds lost $1,147,000,000 – that of the Florida Pension Plans alone lost $325 million. Insurance companies lost $1,571,412,000 with John Hancock and Aegon topping the list in their sector. The bank system was the biggest loser with $5,434,800,000 reported, and the U.S. share of bank losses was $3.3 billion. The largest bank losses by far were from J.P. Morgan Chase with $2.6 billion. (All these figures are shown below in a table in Appendix II.)

Note that the figure for banks would be considerably larger but for Citigroup's reported success in shifting most of their exposure onto unidentified investors through a special purpose off-shore entity that sold securities whose yield was enhanced by a short-option position on Enron's creditworthiness. When Enron filed for bankruptcy, Citigroup exercised its option and the credit exposure was transferred to the investors.

Other energy companies reported losses of $535,000,000, while Enron's employees are reported to have lost $1 billion.

Together these losses total to $9.7 billion. This is less than most estimates of the total losses, but by listing these details on a firm by firm basis it serves to highlight how widely the damages were distributed.

The failure of Enron was not apocalyptic and it did not bring down the entire system. That's a good thing. Had its impact reached that level of destruction, then the national public interest in seeking regulatory remedy for these financial activities would be apparent to all but the most extreme free market advocates.

The failure of Enron did inflict large damages on individuals, firms and the overall economy in the U.S. and even abroad. The following section details some of the reported losses to pension funds, insurance companies, banks, other energy companies, even waste management companies and of course Enron employees. The damage however was greater than the sum of the losses to the employees and the various businesses that engaged in transactions with Enron. Enron's collapse, and especially the way in which it failed, as cast a depressing pale over U.S. capital markets because of the devastating effect it has had on investment trust and confidence in the integrity of information about the capital markets.

The Role of Derivatives in the Failure of Enron

Derivatives played two roles in Enron's failure: first as farce, and then as tragedy.

The catalyst for Enron's collapse starts from the heavy losses it suffered on real, physical investment in such assets as an electrical power plant in India, a water treatment plant in England, a steel mill in Arkansas, stock in a hi-tech startup telecommunications corporation and ownership of fiber optic broadband capacity across the U.S. It also lost money by investing in ventures designed to create new centralized markets in commodity trading that would dovetail with its wholesale and derivatives trading activities. For example, it tried to create such markets in steel, coal, wood pulp and broadband capacity. When these investments turned bad, Enron turned to creative accounting. It hid debt and moved losses off the books of the parent corporation and into a web of partnerships. It then used these partnerships to fabricate income that was reported by the parent Enron.

Enron used derivatives extensively in the creation of these partnerships and then again in its effort to hide debt and losses while fabricating income.[6] Derivatives were used to capitalize the partnerships and to guarantee them a positive rate of profit. Derivatives were also used to generate income from the partnerships for the parent Enron Corporation.

Eventually the farce ended, although not in humor but in tragedy. The losses became so large that they had to be reported publicly as a $1.2 billion charge against equity. This shocking news attracted greater scrutiny to Enron and its practices. Two top executives left, the SEC announced it was looking into Enron's reporting practices and the company restated income for four prior years to show a $600 million reduction in previously reported earnings. Then the news got really bad. Other energy companies and derivatives traders began to lose confidence in Enron as a derivatives counterparty. Enron's trading partners announced that they would either no longer trade with Enron or they would enter into only short-term transactions while they kept a close watch on the situation.

Enron the derivatives dealer was not regulated as financial institution, and so unlike financial institutions such as banks, securities brokers or futures brokers, it was not separately capitalized and did not maintain adequate capital reserves. What is more, unlike securities transactions and exchange-traded derivatives transactions, the OTC derivatives that Enron dealt in were not subject to collateral or margin requirements. This lack of safety provisions proved a fatal flaw.

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[6]) See the letter written by Enron employee Sherron Watkins explaining some of these transactions, the Powers Report and interviews with Richard Causey by attorney for Wilmer, Cutler and Pickering on December 2, 2001.

The next blow fell when Enron's credit rating was downgraded. This required Enron to post "super margin,"[7] which is a collateral or performance bond on derivatives positions, with their trading counterparties. The implication was Enron had to come up with a substantial amount of fresh capital at a time that it was already in trouble for having inadequate capital. This practice of requiring additional margin (or collateral) once a firm gets into trouble has the structural design flaw that it creates a requirement for additional capital just at the time that it is most expensive if not impossible to obtain. The likely result is to hasten, not dampen, a bankruptcy. For this reason such margin requirements should be considered *crisis accelerators*.

Thus the lack of adequate capital together with the structurally unsound collateral provisions[8] laid the foundation

The need to increase the amount of collateral pledged against positions that had negative asset value (i.e. were losing positions)

The loss of both trust and investment grade credit rating caused Enron's trading volume to evaporate. Without trading volume, Enron could not earn their bid-ask spread as dealer for Enron Online and other derivatives markets, and without the bid-ask times volume there were no longer the enormous trading profits earned in the previous years.

Legislative Remedies for Derivatives Markets

The OTC derivatives markets are very large. At $100 trillion outstanding volume worldwide, and $59.2 trillion[9] outstanding amounts at U.S. banks and securities broker-dealers they are every bit as large that those for stocks, bond, mortgages and other loans. However unlike those markets, OTC derivatives markets are completely unregulated. Securities transactions in stock and bonds are regulated through the Securities and Securities Exchange Act to require securities brokers and dealers to register, report their activities, maintain adequate capital and to follow collateral or margin requirements on their securities transactions. Similar rules apply for futures and options brokers. Banks too must register, report, and maintain adequate capital requirements.

OTC derivatives markets are different. Following the December 2000 passage of the Commodity Futures Modernization Act, those transactions are *excluded* from federal financial regulation. What is more, dealers and derivatives participants in the market need not register, report or maintain adequate capital. Only if an institution is already subject to federal financial regulation for some other line of business such as securities broker or banking does the financial

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[7]) The term "super margin" refers to the practice of requiring a counterparty to pledge a great amount of capital against their position in the event their credit rating diminishes and especially when their credit rating falls below investment grade.

[8]) Note that Enron's collapse highlighted other shortcoming in the collateral arrangement. Enron was paying for surety bonds from insurance companies instead of cash or liquid Treasury securities to pledge against some of their derivatives transactions. However Enron's failure led to the insurance companies balking on their payments and the intended recipients (J.P. Morgan Chase) suing to recover their protection. This is clearly an inadequate structure compared to one in which cash or liquidity securities are immediately paid to the derivatives counterparty, which will enable them in turn to meet their collateral requirements, while any legal disputes can commence afterwards.

[9]) DSC calculation from BIS and OCC data. Some options positions reported for broker-dealers may contain exchange traded options.

institution come under regulatory authority. Nonetheless, the transactions themselves still remain outside the authority of any federal regulator.

The following set of prudential financial market regulations would make OTC derivatives markets more safe, sound and transparent. They are similar to regulations that apply to other sectors of the financial system, such as banking, securities and futures trading, and they should be applied to all OTC derivatives dealers and derivatives transactions in order to improve safety and soundness and to maintain regulatory parity.

In order to establish extend to same prudential regulation to derivatives market and establish a more level regulatory playing field for all sectors of the financial system, the OTC derivatives markets

First, establish capital requirements and margin (collateral) requirements. Capital requirements are critical to prevent the problems at one firm from becoming problems at another firm; and they prevent short-term problems at a dealer from causing the market to freeze-up or meltdown. Margin (collateral) requirements do the same for each transaction. The current market practice, in so far there is one, is dangerous. It requires a firm to become "super-margined" if its credit rating drops, and thus initiates a large increase in the need for margin (collateral) just at the time the firm is experiencing problems with inadequate capital. This amounts to a *crisis accelerator.*

Second, establish registration and reporting requirements. All brokers, dealers and other non-end-users of OTC derivatives should be licensed and registered. This is the approach used for securities markets, banking, insurance and exchange-traded derivatives, and it should apply to OTC derivatives markets as well. Reporting requirements will make the markets transparent for the first time, and will give regulators the capability to observe markets to detect problems before they become a crisis.

Third, establish obligations for OTC derivatives dealers to act as market makers. They capture the advantages of their position in the market, and like dealers in U.S. government securities (the most efficient and highly regarded OTC market in the world) they should be obliged to act as market makers throughout the trading day. This will ensure market liquidity was they must maintain bid-ask prices continuously through trading hours.

Appendix I

Market Capitalization

	Pre-Sept 11. 3/1/01 - 9/10/01	Sept. 11th Related 9/10/01 - 10/16/01	Enron Related 10/16/01 - 3/1/02	Annual 3/1/01 - 3/01/02
Natural Gas Utilities				
El Paso	(10,746,918,000)	1,275,750,000	(6,286,896,000)	(15,758,064,000)
Sempra	977,984,000	(406,112,000)	(470,344,000)	101,528,000
Williams	(4,818,855,000)	(757,050,000)	(7,204,850,000)	(12,780,755,000)
Total Natural Gas Utilities	**(14,587,789,000)**	**112,588,000**	**(13,962,090,000)**	**(28,437,291,000)**

Electical Companies				
AEP	(283,536,000)	(715,284,000)	(106,326,000)	(1,105,146,000)
Alliant	(159,000,000)	105,735,000	(193,980,000)	(247,245,000)
Calpine	(4,730,600,000)	(448,644,000)	(6,192,508,000)	(11,371,752,000)
Dominion	(1,213,209,000)	171,189,000	(449,061,000)	(1,491,081,000)
Duke	(1,451,120,000)	85,360,000	(2,646,160,000)	(4,011,920,000)
Dynegy	(2,463,160,000)	1,821,442,000	(6,002,332,000)	(6,644,050,000)
Excelon Corp.	(3,305,270,000)	(3,273,180,000)	1,748,905,000	(4,829,545,000)
First Energy	1,084,160,000	631,680,000	306,880,000	2,022,720,000
Mirant	68,100,000	1,014,690,000	(6,602,295,000)	(5,519,505,000)
NRG	(2,086,235,000)	690,780,000	(1,705,115,000)	(3,100,570,000)
Reliant	(3,469,884,000)	(321,948,000)	(2,319,218,000)	(6,111,050,000)
Southern Co.	3,096,826,200	1,194,024,000	138,840,000	4,429,690,200
Total Electric Utilities	**(14,912,927,800)**	**955,844,000**	**(24,022,370,000)**	**(37,979,453,800)**
Grand Total:	**(29,500,716,800)**	**1,068,432,000**	**(37,984,460,000)**	**(66,416,744,800)**
Enron	(27,080,088,000)	814,212,000	(25,304,653,500)	(51,570,529,500)
Total (Including Enron)	**(56,580,804,800)**	**1,882,644,000**	**(63,289,113,500)**	**(117,987,274,300)**

Appendix II

Total Exposure to Enron

Sector/Company	Amount	Date Reported	Notes
Insurance: Domestic			
ACE Ltd.	0	12/18/01	minimal
American International Group Inc.	69,000,000	2/8/02	
American National Insurance Co.	10,000,000	12/18/01	
AmerUS Group Co.	0	12/18/01	
Chubb	143,000,000	2/8/02	after-tax
CNA Financial Corporation	50,000,000	12/5/01	
CNA Surety Corp	5,000,000	12/20/01	
Erie Family Life Insurance Co.	46,000,000	2/27/02	
Erie Indemnity Co.	4,500,000	2/27/02	
Everest Re Group Ltd	25,000,000	12/20/01	
FBL Financial Group Inc.	7,500,000	12/18/01	pre-tax loss on bonds
Hartford Financial Services Group Inc	12,000,000	1/29/02	
MetLife Inc.	63,000,000	2/7/02	
Odyssey RE Holdings Corp	23,000,000	2/9/02	
PartnerRe Ltd	49,000,000	12/20/01	
Safeco	20,000,000	12/20/01	
Scottish Annuity & Life Holdings Ltd	6,600,000	2/13/02	
Swiss Re	173,000,000	12/20/01	
St. Paul Cos	10,000,000	1/25/02	also estimated 85 million 12/20/01
Transatlantic Holdings Inc	39,000,000	1/7/02	
W.R. Berkley Corp.	0	12/14/01	established 12 mil reserve

XL Capital	75,000,000	1/18/02	
Subtotal - Domestic Insurance	830,600,000		
Insurance: International			
Aegon N.V	300,000,000	12/20/01	dutch insurances giant
Assurances Generales de France SA	45,000,000	12/18/01	French insurer
AXA SA	235,294,118	12/18/01	French insurer euro @ (1/.85)
Converium Ltd.	48,000,000	12/18/01	swiss insurer
Fortis	89,411,765	12/18/01	belgian-dutch insurer euro @ (1/.85)
ING Group	195,000,000	12/3/01	
Royal & Sun Alliance Insureance	0	12/18/01	british insurer
Zurich Financial Services	10,000,000	12/18/01	swiss insurer - insurance exposure
Subtotal - Insurance International	922,705,882		
Total Insurance	1,753,305,882		
Pension Funds			
California Public Employee's Retirement	105,200,000	2/27/02	CALpers nation's largest pension fund
California Teachers Pension Fund	49,000,000	1/29/02	
Florida Pension Plans	325,000,000	2/8/02	Alliance Capital Management
Georgia Pension Plans	127,000,000	2/9/02	
Illinois Pension Plans	25,000,000	1/25/02	
Minnesota Pension Plans	20,000,000	1/23/02	
Missouri Pension Plans	33,000,000	1/25/02	
New York Pension Plans	110,000,000	2/9/02	
NYC Teacher/Firefighter Pension Fund	109,000,000	1/29/02	
Ohio Pension Plans	114,000,000	2/9/02	
Oklahoma Pension Plans	7,000,000	2/9/02	
Tennessee Pension fund	18,000,000	1/31/02	
University of California	145,000,000	2/9/02	
Washington State Investment Board	103,000,000	2/6/02	
Total Pension Funds	1,290,200,000		
Banks: U.S.			
Amalgamated Bank	10,300,000	1/29/02	
Bank of America	231,000,000	2/3/02	
Bank of New York	100,000,000	1/17/02	
Citigroup	228,000,000	1/18/02	
Cullen/Frost Bankers Inc.	0	12/18/01	
J. P. Morgan Chase	2,600,000,000	12/21/01	
Northern Trust	24,500,000	1/18/02	43.5 million total, 24.5 unsecured
Principal Financial Group Inc	171,000,000	12/18/01	
SunTrust	120,000,000	1/10/02	
Wachovia	97,000,000	2/2/02	
Subtotal U.S. Banks	3,581,800,000		
Banks: Non-U.S.			
Abbey National Plc	82,142,857	12/3/01	British Bank pounds @ (1/1.4)
ABN Amro Holding NV	250,000,000	12/3/01	dutch bank
ANZ Banking Group	120,000,000	12/18/01	australian bank
Bank of Montreal	103,000,000	2/6/02	
Barclays Plc	214,285,714	12/3/01	British Bank pounds @ (1/1.4)
Bipop-Carire SpA	18,823,529	2/1/02	between 16-32 mil euros @ (1/.85)

CIBC	215,000,000	12/3/01	canadian bank
Commonwealth Bank of Australia	98,000,000	12/18/01	Australian bank - australian dollar
Credit Agricole SA	146,800,000	12/18/01	french bank
Credit Lyonnais SA	250,000,000	12/18/01	french bank
Dexia	30,000,000	12/18/01	franco-belgian bank
Dresdner Bank AG	100,000,000	12/3/01	german bank
HBOS PLC	0	12/18/01	british bank
National Australia	200,000,000	12/3/01	
Royal Bank of Scotland	428,571,429	12/3/01	British Bank pounds @ (1/1.4)
Societe Generale SA	71,000,000	12/18/01	unsecured ; another 135 mil secured
Subtotal Non-U.S. Banks	2,327,623,529		
Total Banks	5,909,423,529		
Financial Institutions: Other			
American Express	0	12/18/01	
Berkshire Hathaway Inc.	46,000,000	2/5/02	
FBL Financial Group, Inc.	8,412,000	2/7/02	also estimated 9.3 million 12/20/01
John Hancock Financial Services Inc.	320,000,000	12/20/01	
Northern Trust Corp.	43,500,000	1/15/02	was trustee for Enron's 401(k)s
Prudential Financial Inc	266,000,000	2/13/02	credit-related losses
Zurich Financial Services	100,000,000	12/20/01	investment portfolio exposure
Total Financial Institutions: Other	783,912,000		
Energy: U.S.			
AES Corp.	15,000,000	12/18/01	energy
AGL Resources Inc.	0	12/18/01	minimal exposure; energy
Allegheny Energy Inc.	5,000,000	12/18/01	energy
Ameren Corp.	10,000,000	12/18/01	oil&gas
American Electric Power	50,000,000	1/23/02	energy
Atlas Pipeline Partners L.P	0	12/18/01	
Berry Petroleum	0	12/18/01	oil&gas
Cabot Oil & Gas Corp.	2,400,000	12/18/01	oil&gas
Callon Petroleum Co.	0	12/18/01	oil&gas
Chesapeake Energy Corp.	0	12/18/01	energy
Clayton Williams Energy Inc.	4,000,000	12/18/01	based on mark-to-market Nov. 30
Connecticut	220,000,000	1/29/02	solid waste disposal objectives
Conoco Inc.	0	12/18/01	energy
Contour Energy Co.	12,200,000	12/18/01	oil&gas
Denbury Resources	0	12/18/01	cut projected 2002 dev.&exp. by 25 mil
Dominion	97,000,000	1/18/02	
Duke Energy	43,000,000	1/18/02	
EOTT Energy Partners	30,000,000	12/18/01	noncash impairment charge
El Paso Corp	0	12/18/01	unveiled plan to strengthen cap. Struct.
El Paso Electric Corp.	0	12/18/01	
El Paso Energy Partners	0	12/18/01	
EXCO Resources Inc.	15,300,000	12/18/01	terminal all hedging contracts w/ enron
FirstEnergy Corp	2,000,000	12/18/01	energy
Empire District Electric Corp.	0	12/18/01	energy
Genesis Energy L.P.	21,000,000	12/18/01	oil&gas
Goodrich Petroleum Corp.	419,000	12/18/01	oil&gas

Idacorp. Inc.	0	12/18/01	energy
Harken Energy Corp.	0	12/18/01	oil&gas
KCS Energy Inc.	2,800,000	12/18/01	energy
New Jersey Resources Corp.	0	12/18/01	energy
New Power Holdings	110,000,000	12/18/01	charge for terminating contracts; ener
Nicor	5,000,000	12/18/01	oil&gas
Northeast Utilities	0	12/18/01	energy
Northern Boarder Partners L.P.	12,000,000	12/18/01	pipeline
NRG Energy Inc.	10,000,000	12/18/01	power
Nuevo Energy Co	85,000,000	12/18/01	oil/gas
Oneok Inc.	40,000,000	12/18/01	net pretax charge (max); energy
Mariner Energy Inc.	32,000,000	12/18/01	26.2 mil commodity hedge; 5.5 oil/gas
MDU Resources Group	0	12/18/01	oil&gas
Midland Cogeneration Venture L.P.	0	12/18/01	two long-term contracts outstanding
Mirant	57,200,000	12/21/01	possible up to 78.9 mil.; energy
Panaco Inc.	2,800,000	12/18/01	oil&gas
Patina Oil & Gas	6,900,000	12/18/01	oil&gas
Pinnacle West Capital Corp	15,000,000	12/5/01	pretax; energy
Plains All America Pipeline	0	12/18/01	pipeline
PPL Corp.	10,000,000	12/18/01	energy
Prize Energy Corp.	200,000	12/18/01	oil&gas
Pure Resources	2,200,000	12/18/01	oil&gas
Resource America Inc.	75,000	12/18/01	energy
Shaw Group	0	12/18/01	pipeline
Southern Union	0	12/18/01	energy
TECO Energy Inc.	3,500,000	12/18/01	energy
Teppco Partners L.P.	6,000,000	12/18/01	oil&gas
TXU Corp.	20,000,000	12/18/01	high estimate; energy
Vintage Petroleum Inc	300,000	12/18/01	direct enron exposure - has other ind.
Westport Resources Corp	(800,000)	12/18/01	after terminating hedges; energy
WGL Holdings	1,700,000	12/18/01	oil&gas
Williams Energy Partners	0	12/18/01	energy
Wiser Oil Co.	6,100,000	12/18/01	oil&gas
XTO Energy Inc.	30,000,000	12/18/01	on hedges; energy
Subtotal - Energy U.S.	985,294,000		
Energy Non-U.S.			
ARC Energy Trust	0	12/18/01	Candian Energy
Canadian 88 Energy Corp.	0	12/18/01	Candian Energy
Centrica	42,740,000	2/11/02	UK utility
Elektrizitaets-Gesellschaft Laufenburg AG	3,176,471	12/18/01	Swiss; euro @ (1/.85)
Nord Pool	0	12/18/01	Nordic power exchange
Ontario Power Generation Inc.	0	12/18/01	minimal; canadian energy
PanCanadian Energy Services	13,800,000	2/6/02	Candian Energy
Petro-Canada Inc.	21,428,571	2/6/02	canadian dollar @ (1/.7)
PrimeWest Energy Trust	81,900,000	12/18/01	canadian dollar - mark-to-market Dec.
RWE	12,941,176	2/11/02	Germanl euro @ (1/.85)
Tensaka Inc.	3,500,000	12/18/01	Candian Energy
TotalFinaElf	10,000,000	1/30/02	French; between 10-20 mil usd
Union Gas Ltd	10,000,000	2/6/02	candian dollar, after tax @ (1/.7)
Westcoast Energy Inc.	0	12/18/01	Candian Energy

Subtotal - Energy Non- U.S.	199,486,218		
Total Energy	1,184,780,218		
Employees			
Enron US employees		2/18/02	4,500 laid-off
Enron UK employees			1,100 laid-off
Class-Action Lawsuit		2/7/02	21,000 employees lead plaintiff Lacey
Severed Enron Employees Coalition		1/30/02	400 employees lead plaintiff Jordan Lawsuit for 1,000,000,000 - pension loss
401 (k) plan		1/23/02	About 63 % of its assets in Enron stock 20,795 participants. 10 day lock-down or black-out period
Enron Retirement Plan - pension plans	1,200,000,000	2/6/02	15,000 participants
Total Employees	1,200,000,000		
Grand Total	12,121,621,630		

Notes:

On releasing statements on Enron-related losses, most companies suffered related stock-price losses. The effect of this lost market capitalization has not been quantified.

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SPECIAL POLICY BRIEF

Learning Our Lessons: A Short History of Market Manipulation And The Public Interest

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April 9, 2002

Executive Summary:

- It is in the public interest to protect the integrity of prices in derivatives markets by establishing an anti-fraud and anti-manipulation authority. Derivatives prices are "affected with a national public interest. The prices in such transactions are generally quoted and disseminated throughout the United States... for determining the prices to producer and consumer of commodities and the products and by-products thereof and to facilitate the movements thereof in interstate commerce."
- Fraud and manipulation are an ever present danger in these markets and should not be recklessly assumed away.
- One common strategy to manipulate market prices is through the use of derivatives markets, especially non-transparent over-the-counter derivatives markets, because a large position can be amassed and unwound without being observed by the overall market.

Lest we forget....

Congress is beginning to develop the statutory changes needed to address the regulatory gaps and short-comings in federal financial regulations that have been brought to light by the collapse of Enron.

The Feinstein Amendment is designed to establish anti-fraud and anti-manipulation authority over OTC derivatives contracts in energy and metal commodities. Some

may not appreciate why this is so important, while others many not remember how ever-present the danger of fraud and manipulation is to these markets. This Special Policy Brief is intended to help inform the public policy debate by providing background information about the issues of fraud and manipulation, and providing a brief record of the cases that underlie the debate about fraud and manipulation.

What are the public interest concerns with fraud and manipulation?

1) Protecting the integrity of market prices.

Before it was amended in the landmark deregulation bill entitled, "The Commodity Futures Modernization Act," the Commodity Exchange Act contained a prescient statement of the economic justification for the government's role in the economy. In Section 3 of the Act entitled, "Necessity for Regulation," it stated that futures are "affected with a national public interest." "The prices in such transactions are generally quoted and disseminated throughout the United States... for determining the prices to producer and consumer of commodities and the products and by-products thereof and to facilitate the movements thereof in interstate commerce."

In short, these prices are important because they are used not only by those directly involved in the market but also by producers and consumers throughout the economy. Fraud and manipulation are therefore a matter of pubic interest – not just a problem for those who are defrauded or suffer the losing end of the manipulation – because they threaten the integrity of the markets i.e. of the price discovery process.

2) Providing a safe and sound market for risk management.

Derivatives markets provide economically useful tools for hedging and risk management. The extent of their use depends on their affordability, and leverage contributes to their affordability. Leverage also encourages speculation and greater risk taking. Capital and collateral (called margin for exchange traded derivatives and securities) requirements are the pillars of financial market safety and soundness. They function by providing a buffer against losses and a disincentive for excessive risk taking. Like securities markets and the banking sector, a well regulated derivatives market should have capital and collateral requirements that are commensurate with the level of exposure to market risk and credit losses. While this will increase the cost, i.e. lower the affordability of OTC derivatives, the market should benefit overall from the improved investor confidence in the marketplace.

3) Small distortions in market prices can have a large impact on the economy.

Keep in mind that manipulation does not have to be grand in the old fashion way, but can consist of small changes in prices. If prices of winter wheat are off only 3 cents a bushel, and U.S. farmers produce and sell at home and for export 1,612 million bushels, then it will be a $48.36 million cut in income for the farmers on the winter wheat crop alone. That same 3 cents applied to the 9.5 billion bushels of corn would affect income by $285 million – almost six times the impact. That small price change would equal 1% of the nation's net

farm income for all crops. Similarly, consider a manipulation of 3 basis points (0.03%) on Treasury securities. If that has to be paid by the government on all outstanding Treasury securities held by the public, then it would cost the Treasury and hence U.S. taxpayers about $1 billion annually.

The ability of the government to detect and deter fraud and manipulation is dependent on the reporting requirements of market participants. Market prices, trading volume, open interest and larger trader positions are the minimum information needed to maintain adequate market surveillance. This is the standard for exchange traded derivatives and is similar for the stock and government bond market.

How does market manipulation occur and what can be done about it?

Information-based manipulation:

This involves insider trading or making false reports on the market. An example of the former is the manner in which Enron executives made early moves to cash out their employee stock options and sell their security holdings. An example of the latter is illustrated by the way Wall Street firms associated with Enron made "buy" recommendations to their customers and the wider market while enhancing their firms' profits from holding Enron securities, underwriting and other business relationships.

Action-based manipulation:

This involves the deliberate taking of some actions that changes the actual or perceived value of a commodity or asset. For example, managers of a firm short the firm's stock and then announce the loss of an important contract or the closing of factories. After they profitably cover their short positions by buying at lower prices, they negotiate new contracts or reopen the factories. Note that these two examples show that action based manipulation can be combined with insider trading. Similarly, but without insider information, investors may take a position on the stock and then pursue legislation or regulatory changes that might be passed to change the value of the assets.

Trade-based manipulation:

This is the classic case of either unexpectedly amassing a large position in the market, or more likely using one market to capture the gains from creating a price distortion in another interrelated market. How does this work? In the latter case, a manipulator acquires a large long position in the derivatives market in crude oil by entering forward or swap contracts for future delivery or future payments based on the future price of oil. If the derivatives positions were transacted through the OTC market, then neither the government nor any other market competitor would be able to observe the total position of the manipulator. Then the manipulator goes into the spot or cash market for crude oil and amasses a large enough inventory of oil (and also contracts to sell it to buyers who will not resell it) in order to push up the present oil price. This raises the value of the long derivatives positions so that they can be offset or unwound profitably. Then if the manipulator can sell off the amassed inventory without incurring substantial losses, the manipulation will be successful. Keep in mind that the manipulator does not have to buy all the oil in the world, but merely that portion that is to be delivered in the market that is linked to the derivatives contracts. (See the oil price manipulation case below.)

A Few Cases of Market Manipulation

• Electricity Price Manipulation

The Commodities Futures Trading Commission charged Avista Energy and several former Avista traders with manipulating electricity prices and won a $2.1million settlement against Avista Corporation and $160,000 against the traders. The company was charged with manipulating electricity futures prices on the New York Mercantile Exchange (NYMEX) in order to profit from over-the-counter options contracts that were priced off the settlement price in that futures market. The manipulation occurred between April and August of 1998 and involved Avista entering bids at the end of the trading day that were far below (and at other times far above) the prevailing market prices in order to influence the closing price. In addition, Avista traders manipulated the prices through non-competitive trading. The company also failed to keep an adequate record of the positions established through its OTC derivatives contracts.

• More Electricity Price Manipulation

In May 1998, the Enron Corporation paid a fine of $25,000 to the California Power Exchange for violating rules designed to prevent the manipulation of electricity prices on California's day-ahead electricity exchange. Although the violation occurred in the cash market for electricity, efforts to manipulate the cash market price can generate enormous potential gains in derivatives positions.

• Oil Price Manipulation

Tosco won a settlement claiming that Arcadia Petroleum (a British subsidiary of the Japanese firm Mitsui) engineered an elaborate scheme to manipulate oil prices in September of 2001 through the use of OTC derivatives and a large cash market position to corner the market in Brent crude oil. (Brent is a blend of crude oils pumped out of the North Sea and shipped from a terminal at Sheffield Island off Scotland). As a result, the price of Brent Crude soared between August 21st and September 5th and pushed its price to a premium over West Texas Intermediate crude oil (WTI). WTI, which is a higher quality oil, is normally priced about $1 above Brent, but during this period Brent sold for more than $3 above WTI. This artificial price hike occurred at a time of widespread strikes and social protest in Europe.

The following section in italics is taken from the Dow Jones Newswire:

Dated Brent, which acts as a price marker for many international grades, is physical crude traded on an informal market, rather than a regulated futures

exchange. This lack of regulation poses problems for oil producers and consumers seeking a fair price, said Robert Mabro, director of the Oxford Institute for Energy Studies and a leading Brent expert.

"There are regular squeezes in the Brent market," Mabro said. "In the trading community, people are fed up. This general view that you can do whatever you like in an informal market is okay, as long as you regulate the market a bit. But if it's a free-for-all, you're back to the cowboy age."

A typical Brent squeeze involves a company quietly building a strong position in short-term swaps called contracts for difference, or CFD's, for a differential not reflected in current prices. The company then buys enough cargoes in the dated Brent market to drive the physical crude price higher, which boosts the CFD differential, Mabro said.

The company may lose money on the physical side, but it's more than compensated from profits on its offsetting paper position in the short-term swaps market, Mabro said.

"The whole trick is to collect more money in CFDs than you lose on the physical squeeze," Mabro said. "People seem to do it in turn. It depends on who's smart enough to move in a way that nobody notices until it happens."

• Bond Price Manipulation

The CFTC charged two futures traders with manipulating the futures and options market for U.S Treasury bonds in October of 1992. The two sold 13,000 bond futures contracts (roughly $13 billion in notional value) and bought 31,000 put options (roughly $31 billion in notional value). The traders were arrested on the trading floor, expelled from the Chicago Board of Trade, fined $2.25 million by the CFTC and faced criminal charges.

• Soybean Price Manipulation

In the summer of 1989, concerns about possible price manipulation in soybeans and soybean derivatives led to charges that the Italian agribusiness and financial firm Ferruzzi was engineering a classic short squeeze by acquiring a large portion of the cash market while holding about 50% of the open interest in the July 1989 futures market (estimated to be 30 million bushels of actual soybeans including a majority of the 13 million bushels of soybeans in Chicago Board of Trade approved warehouses). Prior to being ordered by the CFTC to liquidate their position, the July futures contract traded at $ 7.26 a bushel, compared with $ 6.90 for August, $ 6.64 for September and $ 6.51 for November. The liquidation turns into a route and Ferruzzi ends up losing $17 million and paying a fine of $2 million plus legal costs.

• U.S. Treasury Securities Price Manipulation

In June of 1993, the CFTC charged that the financial firm Fenchurch used exchange traded derivatives called futures in conjunction with a large share of the cash market to manipulate the interest rate on special collateral repurchase agreements on 10-year U.S Treasury notes and profit by forcing short position holders to deliver a more expensive Treasury security to fulfill the futures contract. Towards the expiration date of the futures contract, Fenchurch held a long futures position of 12,700 contracts (approximately $12.7 billion in notional value) or 76% of the open interest in the market. The repo rate on the 10-year note fell below 0%, i.e. reached negative interest rates, as an indication of the squeeze caused by the Fenchurch strategy. The CFTC sought a fine of $600 million for the violation.

• Copper Manipulation

The CFTC charged the Japanese bank Sumitomo and chief trader Yasuo Hamanaka with manipulating copper prices through an elaborate series of trades using OTC derivatives, exchange traded futures and options on the London Metal Exchange and the cash market for copper in 1995 and 1996. By the fall of 1995, Sumitomo controlled 100% of the copper in LME approved warehouses. As a result, the prices of copper futures contracts, copper spread price differentials, and the prices of cash or physical copper – both in the United States and abroad – reached artificially high levels This enabled Sumitomo to capture large profits by allowing it to liquidate, lend or roll forward its large position at a higher price or price differential.

In addition to Sumitomo, the CFTC charged that Merrill Lynch knowingly and intentionally aided, abetted, and assisted the worldwide manipulation and attempted manipulation of copper prices by providing large sums of credit and finance (reported to have exceeded $0.5 billion). Merrill Lynch benefited from the manipulation through, among other things, its own proprietary trading in the copper market, which was conducted based upon knowledge of the manipulative actions. They ended settling for a fine of $15 million.

Just this April, it was reported J.P. Morgan Chase recently paid $125 million to settle a suit filed by Sumitomo charging that the bank had entered into a series of OTC derivatives contracts that created an off-balance sheet loan to Hamanaka in order to help him finance his trading loses.

According to the CFTC: *The impact on prices and markets in the United States from Sumitomo's conduct was direct and flowed from the well-established and well-known pricing relationships that exist between the LME and the U.S. cash and futures markets. First, the trading on Comex [NYMEX] was directly affected. This was particularly true once the LME established its warehouse in Long Beach, California. During those periods of time when the LME price was manipulated into a premium over the Comex price, stocks in the United States were drawn away from Comex-designated warehouses (principally in Arizona) to LME warehouses (principally in Long Beach, California). Most importantly, the artificial prices and backwardation of prices on the LME also caused prices on the Comex to become similarly distorted and artificial as arbitrage trading between the LME and the*

Comex brought Comex prices higher than they otherwise would have been. Moreover, because copper contracts are generally priced by reference to the LME price or the Comex price, Sumitomo's conduct caused distorted and artificial pricing of copper, including throughout the United States cash market.

• U.S. Treasury Securities Price Manipulation

In 1991, Salomon Brothers, the most prestigious bond trading investment bank at the time, was found to have on at least four occasions violated anti-manipulation laws in the U.S. Treasury securities markets. It also arranged $1.1 billion in questionable repurchase agreements with customers in an apparent attempt to "park" certain securities to keep them out of the market. (Repurchase agreements are transactions that are structured like foreign exchange swaps in which the security or currency is sold today on condition that it be bought back for a certain price in the future.)

The U.S. Treasury securities market was $2.2 trillion at the time, but each security auction is no larger than $14 billion or so. Anti-manipulation rules prevented any one dealer from purchasing more than 35% of any one auction. Instead, Salomon Brothers bought or bid for 57%, 46%, 44% and 85% at four of the auctions between December 1990 and May 1991. Estimates are that other bond market traders lost between $50 to $200 million in just one of the auctions.

The investigation extended to a hedge fund, Steinhardt Partners, that also purchased a large share of at least two of the auctions. There were similar concerns about using repurchase agreements to place recently auctioned securities in foreign banks that would not likely put the securities back into the cash market.

Untangling Enron: The Reforms We Need

Interview with Randall Dodd

This derivatives expert warned about Enron's problems long ago. He believes that there will be other Enrons unless new disclosure and capital requirements are imposed on the over-the-counter derivatives markets. In this interview, he tells us what happened at Enron and how most effectively to prevent its recurrence.

Q Tell us what kind of company Enron was? How did it grow so rapidly? How did it book such profits?

A. Enron was, in essence, two companies. One was an energy supply company that purchased real physical assets such as pipelines and electrical power plants in order to provide energy. The other was a financial institution that functioned as a major dealer in wholesale and derivatives transactions in energy products, other commodities, and some financial derivatives.

Q What is a derivative? Why can it be risky?

A. There are four basic types of derivatives transactions:

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forwards, futures, swaps, and options. These instruments are sometimes combined to form more complicated transactions, but in the vast majority of cases, they are straightforward versions of these four types.

A derivative is a transaction that creates price exposure, that is, exposes the contracting parties to the risk of a change in price based on some underlying commodity, security, interest rate, or event. Derivatives, in contrast to a security or loan, generally do not involve ownership or title. If you buy $100,000 in Treasury notes at par and the price rises 10 percent, then your investment of $100,000 appreciates $10,000, or 10 percent. If you enter into a derivative to buy $100,000 of Treasury notes at par and the price rises 10 percent, then you can sell for a $10,000 gain. The difference is that you never owned the Treasury notes, and your investment was not $100,000 but perhaps as little as $3,000 deposited as margin or collateral. Using a derivative to obtain $100,000 in price exposure with $3,000 in margin means that it is a very leveraged position.

Derivatives can be risky for several reasons. The major reason is that investors can use derivatives to take larger risks than they could otherwise obtain by the use of the capital to directly purchase securities or other assets. Another reason is that derivatives, even when used to reduce or hedge risk, create new risks in the form of credit risk. Credit risk is the exposure to a counterparty's inability to fulfill the derivative contract. Yet another risk is that derivatives markets can become illiquid and prevent the market participants from adjusting or unwinding their positions.

Q How did Enron grow so rapidly?

A. The energy supply business grew rapidly by using debt to purchase a large amount of plant, equipment, and inventory in

the United States and abroad. For instance, two of the biggest losses that triggered its failure were an electric power plant in India and a water treatment facility in the United Kingdom. This rapid accumulation of assets, which was financed by bank loans and debt issuance, produced a high debt-to-equity ratio that was partially hidden from investors through the partnerships known as "special purpose entities." The financial institution grew rapidly by profiting from the broader growth in derivatives trading in general, plus profiting from trading during the energy crisis in California in the summer of 2000. Enron's trading activities were reported to be very innovative and aggressive, and its foray (although ultimately unsuccessful) into trading broadband access and wood pulp certainly bore this out.

Enron made large profits from its trading activities because it was both a dealer and a key market participant in the underlying commodities. Dealers make money in two ways. First, they earn the bid-ask spread as market makers when other market participants come to them to buy or sell. As long as Enron buys at a lower bid price than it sells at its offer price (also called ask price), it earns the bid-ask spread on trading volume. However, if all other market participants cease trading with Enron, then this lucrative business evaporates. Second, it earns speculative profits by taking a position in the market. In this capacity, Enron's dual role as energy supplier and dealer enabled it to have an advantageous "view." It had more information on the market. That enhanced its ability to earn speculative profits trading against other sophisticated and unsophisticated counterparties in the markets.

Q. Give us an example of how that can be an advantage.

A. The energy supply side of the company had the practical knowledge of energy producers about production costs, distribution problems, and sales opportunities, and any changes in that environment could be shared with Enron's trading desk.

On the dealer side of the company, it had the most immediate information about the order flow as market participants came to them to either buy or sell. If there are many more orders to buy than to sell, then it is a clear signal of upward price pressure. Enron as a dealer could share that information directly with its energy-supply operations.

Q Is there evidence that Enron was particularly aggressive about this kind of investing? Was it similar to Long-Term Capital Management (LTCM)?

A. This is precisely where it was most aggressive—and innovative. It created—or at least tried to create—centralized wholesale markets and derivatives markets where none existed before. These included bandwidth access, wood pulp, and nonprecious metals. It also ventured into weather derivatives and online credit derivatives.

LTCM, in contrast, did not create markets but merely sought to gain by trying to exploit pricing irregularities in markets that already existed. Enron both created markets and brought more sophisticated trading efforts to existing markets, while LTCM did only the latter.

Q. Was its success tied to rising energy prices?

A. I do not think its success was tied to rising prices. That would amount to assuming that it was always long, very long. The scuttlebutt I hear is that Enron was long to the same extent that other energy suppliers and wholesale traders were long. The decline in energy prices caused modest losses elsewhere, and by themselves would have resulted in similar modest losses at Enron.

Q Was there a straw that broke Enron's back?

A. There was no one straw or single reason it failed. Rather, it was a case that is best captured by Yogi Berra in explaining the Yankees' loss in the 1960 World Series, "We made too many wrong mistakes."

Here are the major "wrong mistakes" that Enron committed. Enron's energy supply business suffered heavy losses on such ventures as an electrical power plant in India and a water treatment plant in the United Kingdom. Enron also lost money trying to create markets in bandwidth access, steel, and other commodities. Adding to these losses, Enron failed because its management was allegedly caught defrauding the market with false reporting, tax evasion—or misreporting income—and manipulating accounting rules. Derivatives were used in the pursuit of each of these misdeeds. In response to these alleged misdeeds, and the downgrading of Enron's credit ratings, market participants lost trust in Enron and ceased to trade with it. Without the trading volume, Enron was without liquidity and without the volume that turned bid-ask spreads into large earnings. In the end, the greed that led to bad investment decisions, and the apparently criminal behavior that could have led to fraudulent hiding of debt and losses and the fabricating of income, proved to be a deadly combination.

Q Is Enron, then, basically a financial institution? If so, what kinds of regulations do conventional financial institutions have that Enron does not?

A. Enron was a financial institution, and by all appearances a large one. However, it was subject to no federal regulation as a financial institution. The quarterly reports it filed under the securities laws pertained to Enron only as a corporation in general. All corporations that issue publicly traded securities must file such reports. However, financial institutions in the areas of

banking, insurance, mutual funds, pension funds, securities, and brokering of exchange-traded futures and options are subject to some basic safety, soundness, and transparency requirements that Enron and similar over-the-counter derivatives dealers are not. So Enron had no capital requirements, no margin or collateral requirements—the standards used by Enron turned out to be disastrous—no reporting requirements, no licensing or registration requirements, and there was no obligation as a dealer to make a market by maintaining bid and ask quotes as "specialists" on stock exchanges do. Traditional financial institutions must meet all these requirements.

Q What did the Commodity Futures Modernization Act (CFMA) of 2000 do?

A. First, let me point out that the over-the-counter market in derivatives has never been adequately regulated. The market emerged only recently, and most of its growth has occurred in the past fifteen years. At first, this market was largely ignored by regulators, and after it grew to a size that demanded it be addressed, the regulators found it difficult to define the line of jurisdiction over the markets because of poorly written laws and richly endowed political opponents to such regulation.

Before to passage of the bill in December 2000, the government retained authority over fraud and manipulation in the over-the-counter derivatives markets. In addition, market participants were restricted under Rule 35 from conducting over-the-counter markets like an exchange.

The CFMA was a major bill that drastically reduced the level of prudential regulation of derivatives markets. It reduced transparency and the government's surveillance abilities over exchange-traded derivatives, and it completely eliminated or "excluded" federal derivatives regulation of the over-the-

counter market. Enron operated in that completely deregulated environment.

Q Are there other Enrons out there?

A. There certainly are other "Enron" trading firms and "Long-Term Capital Management" hedge funds out there. They may even be as large, but they are unlikely to be characterized by the level of criminal behavior or arrogance as their predecessors.

Q Was there a point at which the federal government could have or should have stepped in?

A. Enron illustrates the problem with the laissez-faire approach to financial markets. Safeguards must be put in place first so that they precede market activity. Once a crisis emerges, there is little that can be done. The only action that might have proved effective was a quick and complete sale of Enron's trading operation that would have restored and ensured an investment-grade credit rating to that part of its business. The efforts to sell to Dynegy came too late and were too burdened by the effort to sell the heavily mortgaged physical assets and the highly leveraged "partnerships."

Q. Could the Enron management or the auditors have intervened soon enough to save the company and its shareholders?

A. In the first place, management should never have created these partnerships and capitalized them in the way it did, and the auditors should never have condoned that activity. Once those actions were committed, the damage only grew over time. Even if the partnerships had all been dissolved within three months, Enron would still have been liable to shareholders for fraud, and it still would have damaged the market's trust in the corporation.

I should point out again that this situation illustrates the importance of having the right rules in place from the beginning.

Q Many people say that the failure of Enron will not affect the financial markets. Is that true? Don't a lot of banks have exposure to the company?

A. The failure of Enron has already had an impact on U.S. and foreign financial markets. Although not cataclysmic, the collapse of Enron did cause substantial damage throughout the financial system. JPMorgan Chase, Citicorp, and the Bank of New York—to name just three—recently announced multi-hundred-million-dollar write-offs from their exposures to Enron. In response, Standard and Poor lowered its outlook for JPMorgan Chase from stable to negative. The second-largest mortgage bank in the United Kingdom lost $160 million, and a couple of Japanese banks lost so much on investments held in money market mutual funds that they had to cut the principal below par on those money market accounts.

As bad as the damages were, the fear was even greater. Back in December, there was a flood of corporate press releases announcing the amount that firms expected to lose due to Enron's bankruptcy. This voluntary publicizing of losses indicated that the fear was greater than the fact. It amounts to an ex-post-facto transparency born out of crisis.

Some say that the hands-off regulatory approach is justified because of the absence of a systemic collapse leading to economic conflagration. That is too high a hurdle and not the right standard for judging whether certain financial activities create a source of vulnerability or instability to the overall economy and thus the public interest. Enron is the largest bankruptcy in U.S. history, and it will inflict substantial damages on U.S. banks, broker-dealers (who are already being sued for under-

writing currently worthless Enron securities), insurance companies and pension funds that invested directly in Enron, energy companies, many small and large investors, and Enron's own employees.

Q What reforms, disclosure requirements, or regulations would you recommend?

A. I would recommend a set of prudential financial market regulations that are of three types. They are similar to regulations in other sectors of the financial system, and they should be applied to all financial institutions and derivatives transactions in order to improve safety and soundness and to maintain regulatory parity.

First, establish capital requirements and collateral-margin requirements. Capital requirements are critical to preventing the problems at one firm from becoming problems at another firm, and they prevent short-term problems at a dealer from causing the market to freeze up or melt down. Collateral-margin requirements do the same for each transaction. Collateral and margin requirements are not designed to protect foo ls from themselves but to protect the rest of us from the fools.

The current market practice for the use of collateral, insofar as there is one, is dangerous. It requires a firm to become "supermargined" if its credit rating drops. This means that a firm must post additional collateral for each position. Thus it requires additional funds just at the time the firm is in trouble for insufficient capital. This amounts to a crisis accelerator.

Second, establish registration and reporting requirements. All derivatives dealers and nonhedges should be licensed and registered for their participation in the markets. This is the same approach for securities markets, banking, insurance, and exchange-traded derivatives, and it should apply to over-the-

counter derivatives markets as well. Reporting requirements will make the markets transparent for the first time and allow the government's market surveillance efforts a chance to detect problems before they become a crisis.

Third, require derivatives dealers to act as market makers throughout the trading day by maintaining bid and ask quotes. They capture the advantages of their position in the market, and, like dealers in U.S. government securities (the most efficient and highly regarded over-the-counter market in the world), they should be obliged to act as market makers throughout the trading day. This will ensure market liquidity as they maintain bid-ask prices continuously through trading hours.

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Testimony of Professor John C. Coffee, Jr.
Adolf A. Berle Professor of Law,
Columbia University School of Law

before the
Committee on Agriculture, Nutrition, and Forestry
United States Senate
on
July 10, 2002

Transparency and Oversight of Energy Derivatives

Introduction

I want to thank the Committee for inviting me to appear today and begin by acknowledging that I am a generalist in the field of financial markets (and a specialist in the fields of securities regulation and corporate governance). However, I do not purport to specialize in derivatives regulation. Although I testified before this Committee at its initial hearing that led up to the Commodity Futures Modernization Act of 2000 (the "CFMA"), that testimony was also from the perspective of a generalist and focused on the need for greater legal certainty at a time when two federal agencies (the SEC and the CFTC) were quarreling about their jurisdictional boundaries.

Today also, I will again comment as a generalist, focusing on the issues of greatest public policy significance. As I see it, the following three stand out:

> 1. Would the amendment to the Commodity Exchange Act ("CEA") proposed by Senator Feinstein (the "Feinstein Amendment") result in significantly increased uncertainty, in effect undoing what the CFMA achieved?
>
> 2. Is there a need for greater transparency regarding the over-the-counter ("OTC") trading of energy derivatives?
>
> 3. Given the natural competition between the OTC market and the exchange traded market in energy derivatives, are there dangers that the Feinstein Amendment could hobble one industry to the advantage of the other? If so, what revisions might be appropriate?

In presenting this testimony, I have reviewed the Feinstein Amendment and representative statements furnished by the International Swaps and Derivatives Association, Inc. ("ISDA") and the New York Mercantile Exchange ("NYMEX").

II. Background

When the CFMA was passed in 2000, the legal status of OTC swaps had become a matter of ongoing controversy. As a result of a highly publicized dispute between Proctor & Gamble

Co. ("P&G") and Bankers Trust Co. ("Bankers"), in which the former had seemingly been overreached in swaps transactions with the latter, both the SEC and the CFTC asserted jurisdiction and brought (and settled) enforcement proceedings against Bankers. Private litigation was also commenced by P&G, which also raised (ultimately unsuccessfully) claims under both statutes.[1] Even more ominous was the fact that the CFTC, under then Chairwoman Born, had suggested that it might rescind or modify the Part 35 Swaps Exemption under which swap transactions amounting to trillions of dollars (in notional value) had been entered into. Understandably, the President's Working Group ("PWG") recommended that greater legal certainty be accorded to OTC financial derivatives by expressly exempting them from the CEA. The PWG limited its recommendation to financial derivatives, and during the hearings on the CFMA, the CFTC expressed reservations about extending the proposed exemption to apply to OTC energy derivatives. As CFTC Chairman Rainier told Congress, financial swaps were typically issued by bank affiliates, securities dealers, or FCMs, who were, respectively, subject to banking regulators, the SEC, or the CFTC. In contrast, the extension of the CFTC to energy derivatives created, he said, "a regulatory gap," as these products were "neither directly regulated as financial products, nor indirectly regulated by an agency with jurisdiction over commercial participants in the energy market."[2] The PWG also believed that OTC financial derivatives were far less susceptible to manipulation than derivatives on commodities and did not perform a price discovery function.[3]

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1 See Proctor & Gamble Co. v. Bankers Trust Co., 925 F.Supp. 1270 (S.D. Ohio 1996).

2 See Testimony of the Honorable William Rainier, Chairman, Commodities Future Trading Commission on June 21, 2000.

3 The basic rationale here is that non-financial commodities have a finite supply and so the market in them can be cornered or squeezed, while this is not true for financial derivatives that are based on interest rates or currency values.

As the CFMA was finally adopted, a compromise was reached under which derivatives based on commodities that are neither financial nor agricultural (a category that chiefly includes metals and energy products) were deemed "exempt commodities," which could be traded by eligible contract participants without CFTC regulation, but which remained subject to certain provisions of the CEA prohibiting fraud and manipulation. In short, the CFMA never truly exempted OTC energy derivatives from most of the fraud and manipulation provisions of the CEA.

Finally, the CFMA authorized the use of exchange-like electronic facilities for the trading of OTC derivatives based on financial commodities and "exempt commodities" (i.e., energy products and minerals). See in particular 7 U.S.C. §2(h). This Section 2(h) exemption was critical for the operation of EnronOnline, which chiefly traded OTC energy swaps, and such electronic facilities will likely be the chief casualty of the Feinstein Amendment.

III. Policy Issues

A. Would the Feinstein Amendment Result in Greatly Enhanced or Unnecessarily Legal Uncertainty?

In my judgment, the Feinstein Amendment does not "undo" the desirable legal certainty that the CFMA created. The original uncertainty that led up to the CFMA arose because both the SEC and the CFTC could dispute whether a complex derivatives transaction was more like a futures contract (in which case the CFTC had jurisdiction) or more like an option (in which case the SEC arguably had jurisdiction). Nothing in the Feinstein Amendment will change the fact that the SEC is now totally out of the picture, as the CFMA amended both the Securities Act of 1933 and the Securities Exchange Act of 1935 to deny the SEC any authority over OTC derivatives (financial and non-financial). See, e.g., Securities Act of 1933, Section 2A, 15 U.S.C. Section 77b-1; Securities Exchange Act of 1934, Section 3A, 15 U.S.C. Section 78c-1.

The OTC derivatives industry has objected, however, that the Feinstein Amendment would eliminate the statutory exemption for transactions in exempt commodities conducted on

an electronic trading facility (7 U.S.C. §2(h)). Although it is true that this exemption would be sharply curtailed, it does not create uncertainty for most OTC energy swaps. This is because the statutory exemption under CEA Section 2(g) will remain available for swap transactions, provided that they are "subject to individual negotiation by the parties" and are "not executed on a trading facility." This exemption remains broad enough to cover the traditional OTC swaps market. Only the new electronic trading facilities (such as EnronOnline) are adversely affected by the proposed amendment of Section 2(h). Even then, the Feinstein Amendment does not prohibit an "electronic trading facility," but simply subjects it to a level of CFTC supervision and oversight similar to that applicable to NYMEX or other futures exchanges. In truth, the only difference between electronic facilities and futures exchanges is that the latter use the "open outcry" system while the former are electronic and automated. This is roughly the same difference between the New York Stock Exchange and Nasdaq, which are subject to the same regulatory regimes. I can discern no policy reason why a difference in the organization of trading (i.e., electronic vs. open outcry) should produce a day-versus-night difference in regulatory regimes in the case of the derivatives industry. Functional substitutes generally merit similar regulation.

Finally, even in those cases when Section 2(g) will not by its terms apply to confer an exemption, there remains the prior common law, as codified in the Part 35 Swaps Exemption, which would again come into play. That exemption worked reasonably well for nearly a decade, and the crisis in "legal uncertainty" that produced the CFMA arose only when (i) the CFTC threatened to repeal the Swaps Exemption, and (ii) the SEC asserted overlapping jurisdiction with the CFTC in some cases. No similar crisis is on the horizon.

The ISDA has also asserted that legal uncertainty will arise because of the overlapping jurisdiction of the CFTC and the Federal Energy Regulatory Commission ("FERC"). There is every reason why their respective jurisdictions should overlap because they have different missions. The CFTC is essentially an investor protection agency, whereas the FERC is more

concerned with the protection of energy consumers. FERC has an interest in the oversight of derivatives transactions only to the extent that such transactions might be used to manipulate and inflate consumer prices. This is in sharp contrast to the former overlap of jurisdictions between the SEC and the CFTC, which are both investor protection agencies (with very different statutory regimes).

B. Is There A Need for Greater Transparency in the OTC Market for Energy Derivatives?

An FERC investigation of Enron's (and others') role in the California energy crisis is still pending, and I will make no assumptions about its eventual conclusions. Nonetheless, it should be remembered that the Presidents Working Group originally recommended an exemption only for OTC trading in financial derivatives, a recommendation that was based in part on the reasonable premise that because financial derivatives are not based on a commodity that has a finite supply, they cannot be easily manipulated. Energy derivatives are at the very least more susceptible to manipulation than are financial derivatives, and hence they stand in need of greater transparency.

A second justification for mandating greater transparency is that OTC energy derivatives and exchange traded energy derivatives are functional substitutes. Congress has long believed that it is important to mandate transparency in exchange-traded energy derivatives (and NYMEX, the party most regulated by this policy, agrees). Yet, if the major users of energy derivatives can "trade in the dark" by substituting OTC swaps for exchange-traded futures, that policy is undercut. Traders on the futures exchanges cannot know if large positions are being taken in the OTC market, and in times of market stress, this uncertainty could destabilize the market. Exactly this diagnosis was reached fifteen years ago by many commentators about the interplay of futures on stock indexes and securities and the danger that limited transparency in one market could affect the other. Following the1987 crash, the Brady Commission proposed the "One Market" concept as the polestar for future reform: namely, the recognition that the New York based equity markets and the Chicago based stock index market constituted a single integrated market that

needed to be regulated consistently. This analysis is as least as apt for energy derivatives, whether traded over-the-counter or on exhanges.

C. Could Regulation Have Ulterior Motives?

Competitors love to subject their rivals to increased regulation - - in effect, to hobble them. For example, for years, the mutual fund industry has been calling for greater regulation of hedge funds. In this light, one has to be at least a little apprehensive that futures exchanges might wish to subject their less regulated competitors - - the electronic trading facility ("ETF") - - to burdensome regulation.

Indeed, one can analogize the ETF to the electronic communications networks (or "ECNs") that now dominate the trading of equities on Nasdaq. ECNs are substantially less regulated by the SEC than traditional exchanges, even though they increasingly compete with exchanges. Clearly, it would be a dubious policy to impose greater regulation on ECNs simply to equalize the relative burdens of regulation.

This analogy can only be carried so far, however, before it breaks down. ECNs are regulated (albeit to a lesser extent than exchanges) as broker-dealers, whereas in contrast ETFs today escape virtually all regulation.

Hence, I would support the transparency, disclosure and reporting obligations in the Feinstein Amendment. However, I do harbor reservations about subjecting ETFs to the CFTC's net capital rules. The net capital rules have long been antiquated, and their original purpose may have little relevance in the ETF context. Brokers-dealers are subject to net capital rules in order to protect their clients (including small retail clients for whom they typically hold cash and securities) against their possible insolvency. ETFs deal only with "eligible participants" who can better fend for themselves. If such persons are apprehensive about a counterparty's credit, they can devise contractual protections (such as a functional substitute for margin), or they could demand that a clearinghouse be developed for the OTC industry (which step the CFMA authorized).

My point is only this: of all the reforms proposed in the Feinstein Amendment, the application of the net capital rules to the OTC energy derivatives market may be the most costly and the least urgently needed.[4] In other respects, I believe that the benefits will outweigh the modest burdens. Functional regulation should require that functionally equivalent markets receive similar levels of regulation. Today, they do not, and the result is that an externality can arise: that is, not only do OTC energy markets escape transparency and oversight, but their ability to do so leaves traders in the more regulated market potentially in the dark.

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[4] My position is not that net capital rules for either market is unwise or counter-productive, but just that the case has not yet been made for extending them to a market populated only by sophisticated parties.

PREPARED STATEMENT OF THE
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.
BEFORE THE
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
UNITED STATES SENATE
JULY 10, 2002

Overview

ISDA is an international organization, and its more than 575 members include the world's leading dealers in OTC derivatives as well as many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial and commodity market risks inherent in their economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

ISDA is pleased to be here today to discuss the existing regulatory authority of the Commodity Futures Trading Commission (CFTC) over swaps and other privately-negotiated derivatives transactions (OTC derivatives) and proposals to amend the Commodity Exchange Act (CEA) to increase the CFTC's authority over these transactions. ISDA believes a rewrite of the Commodity Futures Modernization Act of 2000 (CFMA) is unjustified and that events relating to Enron's collapse do not demonstrate a need for regulation of OTC derivatives.

The current framework for the CFTC's regulatory authority is set forth in the CFMA, which was adopted by Congress with broad bipartisan support after careful consideration over several years by four Congressional Committees, including this Committee, and with the support of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. The CFMA sought to

modernize the Commodity Exchange Act by addressing three main objectives; regulatory relief for the futures exchanges, legal certainty for OTC derivatives, and removal of the ban on single-stock futures trading. With respect to OTC derivatives, the CFMA framework is based on a long-standing consensus among Congress, the CFTC and others that such transactions generally are not appropriately regulated as futures contracts under the CEA. Historically, the CFTC has recognized this fact and has acted to assure that swap transactions are not regulated under the Commodity Exchange Act through issuance of the 1989 Swaps Policy Statement and the 1993 Swaps Exemption. As a result, careful scrutiny should be given to proposals to alter the basic provisions the CFMA applicable to OTC derivatives lest the underlying policy objectives of those provisions be unnecessarily compromised.

Some have suggested that the collapse of Enron Corporation justifies expanding the CFTC's jurisdiction with respect to OTC derivatives. As discussed elsewhere in this statement, ISDA does not believe that this is the case. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron. The Enron failure demonstrated a failure of corporate governance, in which internal control mechanisms were short-circuited by conflicts of interest that enriched certain managers at the expense of the shareholders. Although Enron made use of OTC derivatives, there is no indication that OTC derivatives contributed in any significant way to Enron's collapse.

It has also been alleged that Enron and others engaged in transactions that were intended to manipulate the cash markets for electricity and natural gas in California and that these activities constitute an independent basis for expanding the CFTC's regulatory authority with respect to OTC derivatives. These allegations of manipulation are profoundly disturbing, and ISDA considers it prudent that the appropriate legislative bodies and regulatory authorities investigate them expeditiously and completely.

Existing CFTC Regulatory Authority Concerning OTC Derivatives

Importance of OTC Derivatives

OTC derivatives are powerful tools that enable financial institutions, businesses, governmental entities, and other end users to manage the financial, commodity, credit and other risks that are inherent in their core economic activities. In this way, businesses and other end users of OTC derivatives are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both in the United States and abroad. Almost all OTC derivatives transactions involve sophisticated counterparties, and, unlike the futures markets, there is virtually no "retail" market for these transactions.

The use of OTC derivatives is a positive force in the financial markets. As Federal Reserve Chairman Greenspan noted at a recent Senate Banking Committee hearing (March 7, 2002) "they (derivatives) are a major contributor to the flexibility and resiliency of our financial system. Because remember what derivatives do. They shift risk from those who are undesirous or incapable of absorbing it to those who are." OTC derivatives are used to unbundle risks and transfer those risks to parties that are able and willing to accept them. For example, if a corporation has floating rate debt outstanding and is concerned that interest rates might rise, it could use an interest rate swap to effectively convert its debt into a fixed rate obligation, thereby fixing its exposure. Similarly, if business has the right to receive non-dollar denominated revenues from a foreign-based affiliate, it could use a currency swap to hedge the risk of exposure to fluctuating exchange rates. This Committee has recognized that, as the result of OTC derivatives transactions such as these, "efficiency is enhanced as firms are better able to concentrate on their core economic objectives." S. Rep. No. 106-390 at 2 (2000).

Swaps transactions are custom tailored to meet the unique needs of individual firms. Due to the tailored nature of such transactions, swaps differ substantially from the standardized exchange-traded futures contracts regulated by the CFTC. In a typical OTC derivatives transaction, two counterparties enter into an agreement to exchange

cash flows at periodic intervals during the term of the agreement. The cash flows are determined by applying a prearranged formula to the "notional" principal amount of the transaction. In most cases, such as interest rate swaps, this notional principal amount never changes hands and is merely used as a reference for calculating the cash flows. Almost any kind of OTC derivative can be created. The flexibility and benefits that these transactions provide have led to their dramatic growth. In addition to interest rate and currency transactions, commodity, equity, credit and other types of transactions are widely used. Transactions take place around the world, but the United States has been a leader in the development of OTC derivatives transactions, and American businesses were among the earliest to benefit from these risk management tools. The dramatic growth in the volume and diversity of OTC derivatives transactions is the best evidence of their importance to, and acceptance by, end users.

While its use is a matter of choice among the parties to the transaction, almost all OTC derivatives contracts both within and outside the United States are based on the 1992 Master Agreement published by ISDA. The ISDA Master Agreement is a standard form and governs the legal and credit relationship between counterparties, and incorporates counterparty risk mitigation practices such as netting and allows for collateralization. The ISDA Master Agreement also addresses issues related to bankruptcy and insolvency, such as netting, valuation and payment. The strength of the ISDA documentation and the important actions taken by Congress to ensure that OTC derivatives contracts would be enforceable in accordance with their terms have contributed positively to the ability of the financial and commodity markets to absorb events such as the Enron bankruptcy without systemic risk.

Legal Certainty and the CEA

The availability of OTC derivatives transactions within a strong legal framework is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management

benefits that OTC derivatives transactions provide. One of ISDA's principal goals since its inception has been to promote legal certainty for OTC derivatives transactions.

"Legal certainty" simply means that parties must be certain that the provisions of their OTC derivatives contracts will be enforceable in accordance with their terms. For example, ISDA has sought to establish (i) clarity concerning how OTC derivatives transactions will be treated under the laws and regulations of the United States as well as many other countries; (ii) certainty that OTC derivatives transactions will be legally enforceable in accordance with their terms and not subject to avoidance; and (iii) certainty that key provisions of OTC derivatives transactions (including netting and termination provisions) will be enforceable, even in the case of the bankruptcy of one of the parties.

Within the United States, until the adoption of the CFMA, the CEA was the major source of legal uncertainty with respect to OTC derivatives. As discussed below, both Congress and the CFTC have since the late 1980s acted to provide increased legal certainty for OTC derivatives.

The original version of what is now the CEA was enacted in 1922 to ensure that participants in the commodities futures markets were not defrauded and that those markets, which served significant price discovery functions, were not manipulated. To achieve these objectives, the CEA required, and still requires, that all futures contracts on covered commodities be traded on a government-regulated futures exchange. Under this "exchange-trading requirement", all futures contracts that are not traded on a regulated futures exchange are illegal and unenforceable.

As originally enacted, the CEA applied only with respect to certain agricultural commodities. In 1974, the CEA was substantially revised by (i) establishing the CFTC as an independent agency to administer the CEA; (ii) expanding the definition of "commodity" to include (with certain exceptions) "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with"; and (iii) at

the request of the Treasury Department, providing a statutory exclusion from the CEA for transactions in or involving government securities, foreign currencies and certain other similar commodities.

1989 Swaps Policy Statement. In the late 1980s, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At this time, there was a consensus that OTC derivatives were not "futures" contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA's exchange trading requirement.

To address these concerns, the CFTC issued a Swaps Policy Statement in 1989 stating its view ". . . . that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the CEA. . . ." The CFTC also established a nonexclusive safe harbor for swaps transactions that met certain requirements (e.g., that they were undertaken in connection with a line of business and not marketed to the general public). The Swaps Policy Statement provided legal certainty that the CFTC would not initiate enforcement actions with respect to OTC derivatives that satisfied the safe harbor, but it did not and could not eliminate the risk that a counterparty to an OTC derivatives contract would attempt to avoid its contractual obligations by seeking a court ruling that the contract was an illegal off-exchange "futures" contract.

Futures Trading Practices Act of 1992 (FTPA). In 1992, Congress itself took a major step to provide legal certainty that the CEA was not applicable to OTC derivatives by passing the FTPA. In this important legislation Congress provided the CFTC with explicit statutory authority to issue exemptions from the CEA. The purpose of granting this exemptive authority was ". . . to give the [CFTC] 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."

In passing the FTPA, Congress specifically directed the CFTC to resolve legal certainty concerns with respect to OTC derivatives by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that any class of OTC derivatives transactions were "futures," the Congress made it very clear that granting of an exemption does not ". . .require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the [CEA]."

1993 CFTC Exemptions. In response to the FTPA, the CFTC adopted a series of exemptions. In January 1993, the CFTC issued the Swaps Exemption and an exemption for hybrid instruments. The Swaps Exemption exempted certain types of OTC derivatives, when entered into between sophisticated counterparties, from most provisions of the CEA, including the exchange-trading requirement. In general, the Swaps Exemption covered a broader range of contracts than did the 1989 Swaps Policy Statement, but some types of OTC derivatives were not covered (e.g., other provisions of the CEA precluded application of the Swaps Exemption to OTC derivatives based on securities). In April 1993, the CFTC also issued an exemption for certain contracts involving specified energy products when entered into between commercial participants. This exemption, issued after notice and opportunity for public comment, was also intended to provide legal certainty that the covered energy contracts were not subject to regulation under the CEA.

1998 CFTC Concept Release and Congressional Moratorium. Despite these efforts by Congress and the CFTC to provide increased legal certainty that most OTC derivatives were not appropriately regulated as futures under the CEA, concerns continued to exist. These concerns proved to be neither academic nor speculative. In 1998, the CFTC issued a so-called "Concept Release" on OTC derivatives. As described by this Committee, the Concept Release

> ". . . was perceived by many as foreshadowing possible regulation of these instruments [OTC derivatives] as futures. The possibility of regulatory action had considerable ramifications, given the size and importance of the OTC market. This action [by the CFTC] significantly magnified the long-standing legal uncertainty surrounding these instruments, raising concerns in the OTC market, including suggestions it would cause portions of the market to move overseas.

> "This prospect led the Treasury, the Fed and the SEC to oppose the concept release and request that Congress enact a moratorium on the CFTC's ability to regulate these instruments until after the [President's] Working Group [on Financial Markets] could complete a study of the issue. As a result, Congress passed a six-month moratorium on the CFTC's ability to regulate OTC derivatives." S. Rep. No. 106-390 (2000).

1999 President's Working Group Report. On November 15, 1999, the President's Working Group on Financial Markets issued its report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act.* The Report reflected an extraordinary consensus reached by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. It recommended that Congress enact legislation explicitly to clarify that most OTC derivatives transactions involving financial commodities generally are excluded from the CEA. As stated in the Report, ". . . an environment of legal certainty . . . will help reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector". Indeed, as the Report also noted, the failure to enact such legislation ". . . would perpetuate legal uncertainty and impose unnecessary regulatory burdens and constraints upon the development of these markets within the United States".
The report is available at: **http://www.ustreas.gov/press/releases/report3086.htm**

Commodity Futures Modernization Act of 2000 (CFMA). In December 2000, Congress passed the CFMA. This specific legislation was the product of more than two years of consideration. Four Committees of the Congress held hearings on and formally approved the legislation. At these hearings and elsewhere, key financial regulators (the Treasury, the Federal Reserve, the SEC and the CFTC) and other interested parties presented and debated the merits of various alternative proposals. At each stage of its consideration, bipartisan majorities approved the CFMA.

The principal purpose of the legislation was to eliminate, and not merely reduce, uncertainty with respect to the legal and regulatory status of most OTC derivatives

transactions involving sophisticated counterparties. In this respect, as demonstrated by the preceding discussion, the CFMA did not mark a radical departure from prior policy. For more than a decade prior to passage of the CFMA, Congress and the CFTC had worked diligently and almost without exception to provide increased legal certainty that OTC derivatives transactions were not appropriately regulated as futures contracts under the CEA. The CFMA is a culmination of a long and deliberate process to provide legal certainty for OTC derivatives and thereby reduce systemic risk and promote financial innovation. A detailed analysis of the CFMA is available on ISDA's web site: Comment Letters 1/5/2002: www.isda.org.

Proposals to Expand CFTC Authority

In light of the foregoing history, careful scrutiny should be given to proposals to alter the basic and long-standing policy that underpins the provisions of the CFMA applicable to OTC derivatives; namely, that most such transactions are not appropriately regulated as futures under the CFMA. Although Congress adopted the CFMA less than two years ago, two subsequent events have prompted some to suggest that the CEA should be amended to provide increased regulation of OTC derivatives by the CFTC. These events are the collapse of Enron and the disclosure of transactions by Enron and others in or with respect to the California energy market. The most specific proposal for expansion of the CFTC's authority was contained in an amendment offered by Senator Feinstein and others to S. 517 earlier this year. As discussed below, ISDA joined with many organizations and firms in opposing the amendment, as did the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System and the Chairman of the CFTC and the Chairman of the Securities and Exchange Commission. Before turning to Senator Feinstein's amendment, it is useful to consider the two events now cited as support for proposals to expand the CFTC's jurisdiction over OTC derivatives.

The Enron Bankruptcy

The well-publicized events leading to Enron's bankruptcy filing in December 2001 have raised serious concerns involving accounting practices, securities law disclosures and

corporate governance policies. ISDA shares the view that these issues deserve serious attention by policymakers and that, once the relevant facts are known, appropriate remedial actions should be taken. Some commentators have suggested, however, that Enron's OTC derivatives activities caused its demise and have concluded that this demonstrates the need for increased regulation of OTC derivatives by the CFTC.

ISDA disagrees. In a study entitled "Enron: Corporate Failure, Market Success", released in April 2002 (available on ISDA's web site), ISDA concluded the reasons for the failure of Enron did not, and does not, warrant new federal regulation of OTC derivatives. Had Enron complied with accounting and disclosure requirements it could not have built the "house of cards" that eventually led to its downfall.

The chain of events leading to Enron's bankruptcy simply does not warrant an expansion of the CFTC's regulatory authority with respect to OTC derivatives. With respect to the EnronOnline facility, ISDA understands that EnronOnline was operating prior to the adoption of the CFMA and did not rely on the CFMA for authority to operate. ISDA understands that EnronOnline was a bilateral dealer platform with Enron as the counterparty to every trade. In this respect, EnronOnline represented the migration of bilateral trading over the telephone to trading on the Internet. The sophisticated counterparties that entered into transactions with Enron through the Enron Online facility understood that they were bearing the credit risk with respect to Enron. That risk was handled by Enron's counterparties through methods such as the use of master agreements with close-out netting provisions and use of collateral arrangements.

These counterparties also benefited from provisions of the Bankruptcy Code adopted by Congress in 1990 that recognize the enforceability of close-out netting and from the legal certainty provisions of the CFMA that prevented Enron from walking away from unprofitable OTC derivatives transactions by asserting that they were illegal off-exchange "futures" contracts. Enron also allegedly used OTC derivatives in purported hedging transactions with partnerships it apparently controlled, but these related-party transactions clearly raise issues with respect to accounting and securities law disclosures.

Enron's off balance sheet activities actions appear to have been undertaken to mislead the market by creating the appearance of greater creditworthiness and financial stability than was in fact the case. The market in the end exercised the ultimate sanction over the firm. Even after Enron failed, the market for swaps and other derivatives worked as expected and experienced no apparent disruption. The OTC derivative market did not fail to function in the Enron episode.

Indeed, market participants have learned much about risk management in recent years. Considering the size of Enron, it is important to note that its failure did not have a systemic impact. While its counterparties, creditors, shareholders, and employees have incurred financial harm, Enron's failure did not lead to a failure of other firms.

In a special report published on February 19, 2002, The Financial Times set out an agenda for reform in response to events at Enron. In an article that is part of that special report entitled "A fresh look at rules for energy and finance", the Financial Times concludes that there is no need to regulate energy trading companies but there is a need for clearer reporting. This article notes that an "obvious response" to Enron's demise would be to revisit the exemption for Enron's energy trading from CFTC supervision. But the article cautions against pursuing this obvious response, reasoning as follows:

"But before rushing to bring energy trading - and other unregulated professional and electronic markets - within the scope of the CFTC, it is worth considering what happened to these markets after Enron's collapse ... Nothing happened. The disappearance of a huge participant might have been expected to have a big impact on US energy markets. Yet the lights stayed on, the gas continued to flow. Because they were professional-to-professional markets, there was no damaging impact on consumers."

As documented earlier in this statement, the CFMA was the result of thorough and open discussions by key policymakers and others over a period of years. It produced real gains in terms of legal certainty, an improved and flexible approach to regulation of the futures markets and enhanced the leadership position of the United States in financial

markets. The Enron collapse does not provide an acceptable policy basis for reversing that progress.

The California Energy Transactions

The equally well-publicized transactions of Enron and others in or with respect to the California energy market have raised different public policy questions, namely, the design of the California electricity market, the lack of adequate reserves, demand response relative to growing electricity demand and possible manipulation of the wholesale market. ISDA views any credible allegations of "manipulation" in financial or other markets as a serious matter requiring attention and supports investigations by Congressional Committees, as well as federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC) and the Department of Justice.

ISDA shares the view expressed by key regulators during the recent floor debate on Senator Feinstein's amendment that it would be premature to craft and adopt specific legislative changes before the various inquiries and investigations have been concluded. Congress will have to determine, on the basis of the facts as finally known, whether existing regulations were violated and whether an expansion of the authority of the FERC or the CFTC is necessary and appropriate to address the problems experienced in the California energy markets. For example, it is not obvious why the CFTC would be an appropriate regulator of the electricity market in California.

Senator Feinstein's Amendment

ISDA opposed Senator Feinstein's amendment when it was initially offered in March and remains opposed to this effort. Key financial regulators including the Commodity Futures Trading Commission, the Securities and Exchange Commission, the Federal Reserve and the Treasury Department and over 50 entities in the financial services and energy industries also opposed the Feinstein amendment. It was ultimately defeated in a cloture motion on April 10, 2002.

ISDA believed then, and believes now, that this amendment should first be considered by the committees of the Senate and House that have jurisdiction with respect to the CEA. ISDA appreciates the willingness of this Committee to hold these hearings to fully discuss these important issues.

ISDA has also been of the view that the pending investigations should be completed before substantive amendments to the CEA are considered. To that end, ISDA opposes any future attempts to attach this amendment to pending Senate legislation prior to completion of these investigations.

In addition to these objections, ISDA also had substantial substantive concerns with respect to Senator Feinstein's amendment. As the amendment was presented to the Senate during the debate on S. 517, these concerns included the following:

1. Subsequent to its introduction, the amendment was modified so that it would no longer apply directly to financial derivatives such as interest rate swaps and securities based swaps, but it was not certain that these modifications were adequate to prevent the amendment from creating new legal uncertainty with respect to one or more types of financial derivatives.

2. The amendment is anticompetitive, as it did not apply simply to energy derivatives, but also to other exempt commodities such as metals. As a result, there would have been new and burdensome regulation of contracts (and parties to those contracts) in products that were not involved in the California energy transactions and for which the need for regulation was considered by Congress as unnecessary in 2000.

3. Even if the scope of the amendment was limited to energy (and any potential indirect effects on other OTC derivatives were eliminated), the amendment was still deficient. For example:

a. Provisions of the amendment would have applied to any contracts in a covered commodity, whether or not that contract is a derivative or would otherwise be subject to regulation by the CFTC as a futures contract or commodity option.

b. The definition of "trading facility" was broader than current law and could conceivably have encompassed business contacts by telephone, email, and the like. The definition was not limited to exchange-style trading systems or traditional dealers and could have been interpreted to apply to the trading activities of a broad range of market participants.

c. The OTC derivatives business cannot practically be conducted under a regulatory framework for market intermediaries that is based on the CFTC's existing regulation of futures commission merchants, particularly in terms of net capital and similar requirements. The CFTC's historic mission has not involved the oversight of dealer activities, and the necessary supervisory expertise is not now within the CFTC's core competencies.

d. In allocating jurisdiction between the CFTC and FERC, the amendment gave FERC jurisdiction over derivatives involving electricity and natural gas that are excluded from regulation under the CEA, a category of transactions that is not now within FERC's jurisdiction.

Conclusion

OTC derivatives are a major contributor to the flexibility and resiliency of our financial system that allows businesses, financial institutions, governmental entities and other end users to manage the financial and commodity market risks inherent in their economic activities. The CFMA established an appropriate regulatory structure for OTC derivatives by providing legal certainty consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts. This policy materially reduces systemic risk and creates a climate in which entities are able to manage risk in an efficient and effective manner.

Based on the facts now available, recent events do not justify rewriting the CFMA framework with respect to OTC derivatives. Indeed, it appears that the CFMA and the related provisions of the Bankruptcy Code may have enhanced the ability of market participants to deal with events such as the collapse of Enron.

New York
Mercantile Exchange
NYMEX/COMEX Two divisions, one marketplace.

Statement of Neal L. Wolkoff,
Executive Vice President and Chief Operating Officer

New York Mercantile Exchange, Inc.

Before the United States Senate Committee on
Agriculture, Nutrition, and Forestry

"Commodity Derivatives Trading Oversight"

10:00 a.m., July 10, 2002

Mr. Chairman, my name is Neal Wolkoff. I am the Executive Vice President and Chief Operating Officer of the New York Mercantile Exchange, Inc. ("NYMEX" or the "Exchange"), which is the world's largest forum for the trading and clearing of energy contracts. As you and the other members of this committee know, NYMEX is a federally chartered marketplace, fully regulated by the independent federal regulatory agency, the Commodity Futures Trading Commission ("CFTC" or the "Commission"). On behalf of the Exchange, its Board of Directors and members, I want to thank you and all the members of the committee for the opportunity to participate in today's hearing to study and discuss regulatory issues in the energy marketplace.

Beginning with the turmoil leading up to the Enron bankruptcy last December, and continuing through the recent revelations of controversial trading practices, the energy marketplace and many participants have faced unprecedented challenges. A number of significant market participants have experienced dramatic reductions in stock valuation, and credit rating downgrades. A continuation of that trend could seriously threaten liquidity in the cash commodity energy marketplace. Loss of liquidity and reduced competition clearly will translate to higher energy costs for consumers, and will serve as another stumbling block to a U.S. economy seeking to recover from the recent downturn.

As this committee and other policy makers and regulatory officials consider what legislative or regulatory remedies may be necessary, the admonition often attributed to Hippocrates, "First, do no harm," comes to mind. In our 130 years as an organized commodity exchange, NYMEX has had to deal with a number of serious crises involving shifts in energy market prices or involving energy market participants. That experience leads us to believe that this current situation can be dealt with effectively after a careful examination of the situation.

In prior hearings, we have stated our position that we believe a regulatory gap exists in energy and metals market oversight. Specifically, fully unregulated central marketplaces have developed for the trading and discovery of price of physical and derivatives markets. We recommend, as detailed below, adoption of specific measures pertaining to these unregulated electronic central marketplaces. We do not recommend a significant increase in the scope of regulation addressed to the participants in those markets, and believe that the approach of the Feinstein-Fitzgerald amendment, which called for record retention among market participants in unregulated central markets is generally sufficient.[1] NYMEX believes that recent events have underscored the existence of the previously mentioned regulatory gap. Among the several legislative proposals, it is our belief that legislation developed and sponsored by Senator Dianne Feinstein and Senator Peter Fitzgerald is a targeted approach to eliminate the regulatory gap.

Our testimony today will begin with a description of the energy marketplace that is served by NYMEX, followed by a summary of the regulatory oversight under which we operate, and its relationship to the over-the-counter energy marketplace. The importance of an efficient, liquid, transparent market is emphasized next as we illustrate, using recent examples, the critical role competitive markets play in times of significant uncertainty. Then we will offer a brief description of the market response to problems arising from the Enron collapse. Finally, our discussion will focus on the market impact and other issues, including regulatory matters, arising from the Enron bankruptcy and

[1] In the adoption of the Commodity Futures Modernization Act, the CFTC's Part 35 prohibition against wash trading, which had applied to all off-exchange derivatives transactions, was eliminated. There are sound reasons to reverse that decision, although we believe that accounting rules and securities laws already prohibit such trades. Since this is a current prohibition in other bodies of law, we would not see a re-introduction of the prohibition in the Commodity Exchange Act to constitute "new regulation."

the more recent revelations of controversial trading practices by certain energy market participants, followed by a discussion of legislative and regulatory issues linked to current market concerns. Our remarks today will be presented in the following order:

- **The Energy and Metals Marketplace - The Role of NYMEX**
- **NYMEX is Regulated by the Commodity Futures Trading Commission**
- **The Critical Value of Competitive, Liquid, Transparent Markets in a Crisis is Proved Over the Past Decade**
- **The Enron Collapse Provided a Further Test of the Marketplace**
- **Legislative and Regulatory Issues**

The Energy and Metals Marketplace - The Role of NYMEX

The New York Mercantile Exchange, Inc., was established in 1872, and has grown to become the world's largest exchange for energy and precious metals. As a regulated commodity futures and options exchange, NYMEX has served a diverse domestic and international customer base by bringing price transparency, competition, market neutrality and efficiency to energy and metals markets, and provides businesses with the financial tools to deal with market uncertainty. While much of our testimony focuses on the energy marketplace, the same principles outlined below apply to the metals marketplace.

Although NYMEX is predominantly a marketplace for commercial participants in the energy realm to hedge risk and to discover prices on large volume transactions, the benefits of this marketplace accrue to the consumers of energy who receive prices based on open and fair competition. In addition to prices being competitively determined on NYMEX, the Exchange also assures that the prices for all transactions occurring on its floor are transparent. They are disseminated world-wide immediately upon execution via the market ticker, and are accessible real-time through a variety of market data vendor services.

The transparency of NYMEX prices, and the integrity of its markets, makes NYMEX a widely accepted and reliable benchmark for energy pricing which is vital to our economy. The visible and highly competitive daily transactions of energy futures and options on the exchange provide a true world reference price for each of the commodities traded. In the aftermath of the collapse of Enron, NYMEX has played a leading role in ensuring against a broader financial adversity in the energy marketplace through its secure liquid market.

In addition to price transparency, the Exchange is used and relied upon as an open forum for hedging energy price risk. Risk shifting, in the secure liquid markets that NYMEX provides, allows commercial interests to "hedge" the risk of price fluctuations that could affect planning of their business operations, and consequently profitability, by using futures and options contracts to "lock in" energy costs.

NYMEX publishes settlement prices each day reflecting the value of each commodity and contract month. Because the settlements reflect actual trades, and not market sentiment, they are relied

upon heavily by the energy industry as benchmarks for many physical and OTC contracts. NYMEX has recently received a copyright designation for this.

Along with the openness and transparency of its trade execution operations, NYMEX's clearinghouse protects all participants against counterparty credit risk, which is simply the risk of failure of either one of the two parties to a transaction (the buyer or the seller) to pay such funds as they become due to his counterpart as a result of the trade. Through a system of cross guaranties among the brokerage firms and banks that comprise NYMEX's clearinghouse, credit risk is removed from each participant, because financial performance is guaranteed by the Exchange and backed by its clearing members. Customer funds are held by the Exchange and its clearing members in trust accounts that are fully segregated from the exposure and funds of the clearing firm or the Exchange itself. Over-the-counter ("OTC") or off-Exchange, transactions do not carry this level of protection against credit exposure.

NYMEX is Regulated by the Commodity Futures Trading Commission

The federal government has long recognized the unique economic benefit futures trading provides for price discovery and managing price risk. The Senate Agriculture and Natural Resources Committee, as a primary overseer of United States commodity markets, has played a key role in creating a regulatory framework that has been so successful over the years. The modern era of commodity market regulation began in 1974, when Congress created the Commodity Futures Trading Commission, giving it authority to regulate commodity futures and related trading in the U.S. A primary function of the CFTC is to ensure the economic utility of futures markets as hedging and price discovery vehicles—encouraging transparency, competitiveness, efficiency, and market and trade practice integrity and fairness. Regulated markets must file all terms and conditions of contracts, and contract changes, with the CFTC. The Commission also oversees registration of firms and individuals who either handle customer funds or give trading advice. It conducts and monitors rule enforcement at U.S. futures exchanges.

As part of the federal mandate, NYMEX performs many self regulatory functions, and its rule enforcement program is under the jurisdiction and watchful scrutiny of the CFTC. As a designated Self Regulatory Organization ("SRO") NYMEX is responsible to police the conduct of its members and markets, and to adopt rules which are designed to protect the public interest. The Exchange expends considerable resources to maintain a compliance function, including market and financial surveillance, as well as a disciplinary process for those who might violate any of the Exchange's rules. Of course, unregulated electronic central marketplaces do not have an SRO designation, and operate without participant rules or an investigative or enforcement mechanism. The CFTC also lacks routine tools to oversee the conduct of these marketplaces.[1]

Unregulated Physical Markets Also Evolved to Provide Risk Management

Another component of the energy marketplace is comprised of exchanges and intermediaries not falling under the jurisdiction of the CFTC, and, thus are largely unregulated. These markets, referred to as OTC or derivatives markets have grown rapidly – particularly over the past decade. The trading

[1] In order to investigate possible fraud or manipulation on an unregulated electronic market, the CFTC needs to make a "Special Call" for information, and has no broad record inspection rights as a matter of course as it does with an exchange. The electronic markets themselves also are not subject to antifraud or antimanipulation rules, and so have no incentive or obligation to adopt rules governing proper market conduct, and have no mechanism to police their participants.

subsidiary of Enron, EnronOnline ("EOL"), was, prior to the parent's financial failure, a marketplace for physical delivery of energy products (meaning that buyers and sellers actually intended to make or take delivery of the commodity bought or sold), and also for unregulated financial instruments called "swaps." In addition to EnronOnline, a number of other electronic trading platforms, and telephone brokers offer OTC instruments that look and function similarly to or identically to NYMEX' contracts. There are, however, several key differences between these platforms and the NYMEX marketplace:

- **The counterparties bear the credit risk of each other – these transactions are not cleared;**
- **Pricing is not transparent to the public; and**
- **The platforms are not regulated, and have no obligation to police themselves for fraud, manipulation or other misconduct.**

An OTC deal is a contract usually arranged through an intermediary such as a major bank or the trading wing of an energy company. As compared to a standardized contract traded on a futures exchange, while an OTC deal can involve customized terms, the great majority of OTC energy swaps in recent years generally have involved standardized terms with the exception of credit terms. A swap is generally exemplified by an agreement whereby a floating price is exchanged for a fixed price over a specified period, thus allowing a buyer or seller of energy products to "lock in" a specific price, and avoid the risk of floating prices. The economic purpose of an OTC transaction, therefore, is usually the same as the economic purpose of a NYMEX transaction. The swap is a financial arrangement that involves no transfer of physical energy; both parties settle their contractual obligations by means of a transfer of cash. The agreement defines the volume, duration and fixed reference price (which for most contracts in the U.S. for crude oil or natural gas is the NYMEX price). Differences are settled in cash for specific periods – monthly, quarterly or biannually.

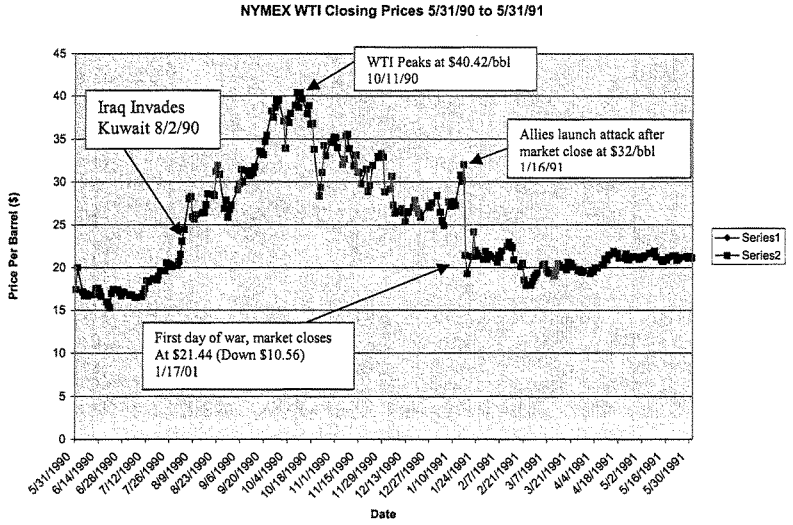
Typically, OTC market participants utilize NYMEX not only as a price reference, but also to hedge their own price exposure resulting from the swap agreements or physical contracts agreed to by the parties. Thus, in the energy marketplace, there is substantial interaction between NYMEX and the physical and OTC energy markets.

The Critical Value of Competitive, Liquid, Transparent Markets in a Crisis is Proved Over the Past Decade

Nothing illustrates the critical value of an efficient, transparent energy market better than the events of the past decade. We refer you to the three following examples of performance during serious market situations over the past decade:

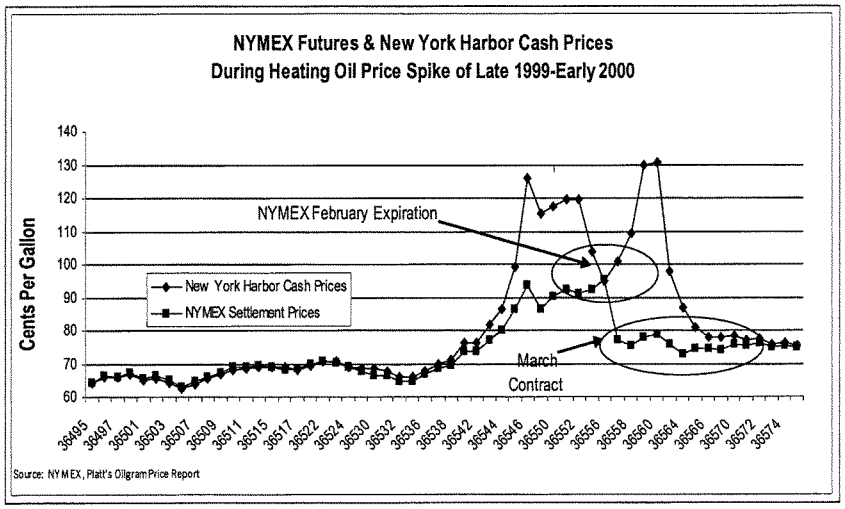
Example 1 –Market Response to Persian Gulf Crisis

Gulf War – Following the invasion of Kuwait, the market rose, but with the development of the international coalition that later conducted "Operation Desert Storm," the market peaked at $40.42/bbl on October 11 (Three months prior to the onset of hostilities-- January 16, 1991). With the market closed the evening the air war started (Jan 16, 1991) anecdotal reports of OTC oil sales of over $60/barrel appeared in the press (NYMEX had closed at $32/bbl). When NYMEX opened the next day, the price dropped by $10.56/bbl to close at $21.44/bbl. The NYMEX market "window" gave critical and constant information to global market participants.



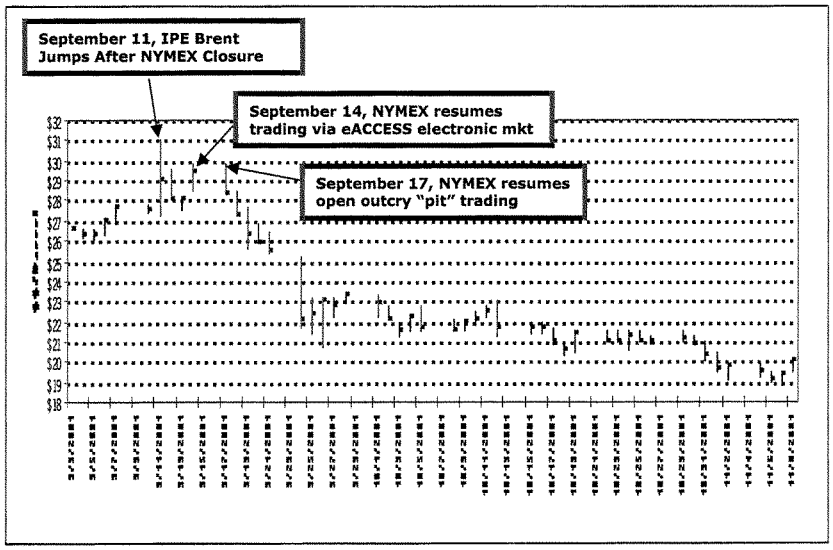
Example 2 – Market Response to Heating Oil Price Spike

Heating Oil Price Spike 1999-2000. Extremely cold weather in January, 2000 caused the New York harbor to freeze, exacerbating an already tight heating oil supply situation. The chart below shows how the expiration and delivery of NYMEX heating oil contract pulled the cash market towards convergence, and sent signals to the market that heating oil was needed. In response to the market signals, additional supplies arrived in early February. Once again, under critical market conditions, the NYMEX market helped participants deal with price volatility, and sent critical signals to increase supplies. (Note: This market action is very similar to that experienced in price spikes in heating oil, gasoline and natural gas markets in 1990, 1994, 1999, respectively.)



Example 3 – Market Response to World Trade Center Attack, September 11, 2001

World Trade Center Attack – With NYMEX closed the morning of September 11 following the attack on the World Trade Center, oil markets jumped by $3/bbl. As NYMEX resumed trading (Friday, September 14 via a special daytime trading session on the eACCESS[sm] electronic trading platform) the market began to adjust, and to use the NYMEX for information and risk management. Open outcry trading began on Monday, September 17.



The three preceding illustrations serve to emphasize two important points:

- Transparent, liquid, and competitive energy markets have provided a critical and valuable service in times of serious market stress.
- As concerns about the current regulatory structure are considered by policy makers and regulators, care must be taken to ensure that any added regulatory measures target problem areas, and do not inhibit critically needed market functions or flexibility.

The Enron Collapse Provided a Further Test of the Marketplace

In the early stages of Enron's difficulties in the fall of 2001, some observers feared that Enron's substantial position in the OTC marketplace could pose serious problems for a significant number of market participants. Those fears were well-founded, although fortunately, they did not come to pass. Enron's counterparties realized the risk in being paired against a company in ever-worsening condition and made alternative arrangements, including transferring positions to the NYMEX.

During that same period, NYMEX used its existing market surveillance tools such as large trader reporting, position limits, and position reporting to alert management to potential problems. In addition to maintaining vigilant monitoring of market positions and margin and other financial information, the Exchange implemented a number of measures to address issues arising from the Enron situation:

- **Margin requirements (cash required as a guarantee of fulfillment of a futures contract) on natural gas contracts were increased.**
- **Approval was sought from, and granted by, the CFTC for the use of EFS ("Exchange of Futures for Swaps") instruments for natural gas to allow market participants to migrate their positions from the OTC marketplace to NYMEX, where financial performance is guaranteed.**
- **Exchange policies to reduce exposure to Enron's credit risk by NYMEX traders were implemented.**

The response of market participants to the measures implemented by NYMEX was dramatic. Indeed, as the measures were enacted, we witnessed a remarkable "flight to quality," as market participants moved to the NYMEX where financial performance is guaranteed by the safety and soundness of a federally regulated clearinghouse.

Legislative and Regulatory Issues

Until all the facts are in, one cannot say with any certainty which of several possible causes brought about the Enron bankruptcy, including regulation or deregulation. However, recent revelations about market practices by several energy market participants have shifted the issue of whether or not regulation is warranted. Instead of looking at the impact of regulation or the lack of regulation as it affected Enron, policy makers are evaluating the need for additional measures based on the broader revelations of questionable market practices.

Episodes like the Enron collapse, where a major market participant fails, heighten the awareness that the Exchange is a safe haven, and that the benefits to doing business on a regulated marketplace hold enormous appeal, or should, to any corporation with credit or price exposure to energy. We believe that corporate boards and treasury offices should become more involved as a matter of their fiduciary obligations to their employees and shareholders to learn about the differences between regulated and unregulated marketplaces. However, we do not believe that business should be compelled to use NYMEX by virtue of a regulatory or legislative fiat.

In a "Special Comment" report dated May 2002, Moody's Investors Research identified significant business reasons for the energy sector to conduct its transactions in a different, more regulated manner: "the lack of regulatory oversight of this [energy trading] activity, and the opaque accounting are not conducive to maintaining counterparty confidence." The Moody's report recognizes that a solution to the current crisis in OTC energy trading requires a "near term," "fundamental restructuring," with self-imposed business solutions. Among its limited suggestions, Moody's recommends "the establishment of a clearing system that would provide liquidity, transparency and a more efficient transfer of credit risk." (Quotations from "Summary Opinion," p.1).

Contemporaneous to the publication of this report, NYMEX, recognizing similar industry issues, planned, and last week implemented, an "OTC" clearing mechanism, which is fully regulated and under the oversight of the CFTC. The CFTC, we might add, has been assertive in overseeing the creation and rules surrounding this new endeavor. We mention it not as evidence of a need for more regulation, but as an example of the marketplace – in this case the regulated marketplace – providing innovative solutions to business problems that take into account the public interest.

We have consistently stated our position that legislation should not be enacted that would have the effect of dictating "winners" or "losers" in the risk management marketplace. During the consideration of the Commodity Futures Modernization Act of 2000 (the "CFMA"), we repeatedly stated our deep concern with a narrow provision targeting energy and metals futures markets. Specifically, while we were supportive of, or neutral to, much of the CFMA, our major concerns centered around a provision that appeared in both the House (H.R. 4541) and Senate (S. 2697) versions of the legislation as introduced in May of 2000. This provision was actively pushed by Enron, among others, and would have exempted energy and, in the House version, metals futures contracts traded on electronic trading platforms from nearly all federal regulatory oversight.

Thankfully, Mr. Chairman, you, and Senator Richard Lugar along with the members of the Senate Agriculture Committee recognized the serious policy flaws with this extreme deregulatory measure, and quite courageously challenged Enron and others, preventing it from becoming law in its most egregious form. Still, as passed, it created a distinction between electronic and open outcry exchanges.

NYMEX had opposed the exemption from its inception, and had supported its elimination from both the Senate and House versions of the CFMA. To this day, we fail to understand the distinction between an exempt exchange doing business electronically, and one doing business on an open-outcry trading floor, should there have been interest in creating such a forum.

The recent spate of revelations of questionable trading practices has added another level of "angst" to an already nervous marketplace. The need is immediate to restore the confidence of the public and market participants. After carefully evaluating various proposals to increase market oversight, we have concluded that a proposal put forth by Senators Dianne Feinstein and Peter Fitzgerald is carefully targeted to correct gaps that currently exist in energy and metals market oversight. Far from being as expansive as some opponents have charged, the Feinstein amendment is narrowly tailored to target a specifically identified gap in energy and metals market oversight. It would not result in forcing all derivatives transactions onto the most heavily regulated markets. Instead, this amendment, while maintaining the flexibility that Congress has provided to emerging markets in terms of how they organize their business lines under various new regulatory tiers, would also give the CFTC additional tools with respect to certain of these new regulatory tiers and other transactions to ensure that the CFTC can obtain necessary information to conduct proper

oversight of such markets and transactions. It does not seek to expand authority to other financial markets, such as involving fixed income or equity swaps, and, frankly, many of our energy market participants have told us they support it. The Feinstein-Fitzgerald amendment deserves support for the following reasons:

- The proposal would refine the definition of trading facility as applied to energy derivatives markets and would further require that any such market not otherwise regulated by the CFTC would be accountable to them.
- In addition, the proposal would give the CFTC vitally important tools to monitor such markets, including large trader reporting.
- The proposal would also ensure that the CFTC has the authority and ability to obtain access to information critical to market oversight and to make market information public to the extent that the Commission determines that it is in the public interest to do so.

In testimony presented over the past decade, NYMEX has consistently supported and advocated the need for the market oversight that the centralized markets provide. Based on our experience as a successful marketplace operation, components important to the marketplace include:

- Position limits
- Large trader reporting
- Surveillance

We believe that CFTC oversight is appropriate and beneficial in areas that provide oversight and uniform standards aimed at protecting the ongoing financial integrity, market integrity and trade practice integrity of the marketplace. We believe that correct emphasis has been placed on the financial integrity and trade practice protections that the self-regulatory structure of this industry has always provided. The deepest, most liquid markets--that provide the most efficient price discovery and risk shifting-- occur on the centralized market, i.e. NYMEX, where market and financial integrity oversight is a routine part of doing business.

We do have some concern that an overly broad legislative response to recent revelations would have a negative impact on all energy markets without providing significant additional regulatory benefits. In particular, we are concerned that the focus of regulation will impose new restrictions on market participants, as opposed to the central marketplaces themselves. The scheme of futures market regulation is focused on the exchanges and brokerage firms which handle customer funds and engage in sales practices. Customer regulation is kept to a minimum, most notably to prevent fraud and manipulation. Those customer standards are already imposed under the CFMA; however, as mentioned above, the central marketplaces (while there are brokers, there is no futures commission merchant equivalent in the OTC marketplace) have managed to escape having any responsibilities, and operate under a purely *caveat emptor* scheme of market oversight. This open hole in the OTC scheme of regulation – albeit light regulation – should be addressed. A deliberate and thoughtful legislative approach is appropriate to avoid drying up market liquidity in the cash commodity energy markets and thus severely harming energy markets that impact on every segment of our economy. As we

stated at the outset, there is real value in avoiding unintended consequences by striving to do no harm.

It is important that the Senate take this opportunity to restore public faith and confidence in our competitive markets. The amendment's provisions addressing regulatory gaps in the CFTC regulatory "umbrella" can provide an important, meaningful and carefully focused improvement in market oversight, and is an important step in rebuilding faith and confidence in a competitive energy marketplace.

The energy marketplace has dealt with many crises effectively

Chief among the lessons to be learned taken from the Enron bankruptcy is the value provided by the federally chartered, regulated commodity marketplace in supplying market oversight and credit enhancement. The ability of market participants to move from largely unregulated trading platforms to the Exchange where transparency, liquidity, and market oversight are the applicable watchwords, proved to be of critical value in avoiding broad ranging disruptions as Enron's problems became known. In this regard, we also wish to note that the CFTC acted expeditiously in recent weeks to approve a new NYMEX initiative that facilitates the movement of OTC transactions onto our more transparent and regulated exchange by allowing such transactions to be converted into regulated futures positions and eventually to be cleared by the Exchange.

The situation could have been far different had the unwise proposal to nearly completely eliminate regulatory oversight of energy and metals futures and options contracts traded on electronic trading platforms been adopted as originally proposed in the CFMA legislation in 2000. As it turned out, market participants availed themselves of the safety and credit enhancement provided by the regulated marketplace.

The broader concerns arising from questionable trading practices which have recently come to light serve to illustrate a regulatory gap which we have identified and discussed in prior testimony. As Congress moves forward in the examination of the complex issues arising from the Enron bankruptcy, and in consideration of how the benefits of transparency, market oversight, and enhanced competition can be extended to the broader energy marketplace, including that of electricity, these lessons should be remembered. We believe that the legislation developed by Senator Feinstein and co sponsored by Senator Fitzgerald corrects the current gaps in oversight and accountability, and will provide a sound basis for building public confidence in the fairness and transparency of the energy and metals marketplace.

Once again, Mr. Chairman, thank you for the opportunity to participate in this important discussion.

Statement of Richard C. Green
Chairman of Aquila, Inc.

Before the Committee on Agriculture, Nutrition, and Forestry
United States Senate
Wednesday July 10, 2002

Thank you, Chairman Harkin and members of the Committee.

As Chairman of Aquila, I appreciate the opportunity to testify on the existing regulatory authority of the Commodity Futures Trading Commission (CFTC) over markets in over-the-counter derivatives, and to look at whether CFTC's authority should be increased in order to prevent fraud and market manipulation. Let me emphasize that I am speaking for Aquila alone today and not for anyone else in our industry.

Aquila is an integrated energy and risk management company based in Kansas City, Missouri with customers and operations across the United States, Canada, Europe, New Zealand and Australia. We own traditional investor owned-utilities in mostly non-urban areas of Missouri, Kansas, Colorado, Nebraska, Iowa, Michigan and Minnesota. We also own and operate generation, transmission, distribution, and gas storage facilities.

Until recently, we were very active in the energy trading business, both in electricity and natural gas. In fact, we were in that business from its inception, rising to be consistently the nation's number two or number three trader in natural gas or electricity. On June 17, we initiated a restructuring that included significant downsizing of our trading operations in both electricity and gas due to the tightening credit and capital requirements for energy traders.

Mr. Chairman, let me start by applauding the Committee for seeking input from the electricity and natural gas trading industry, primarily as it relates to commodities trading and the use of derivatives. I have three main points that I want to make today.

First, it is clear that the Enron collapse has had an enormous impact on shareholders and employees of energy trading companies. Irrespective of a company's track record or its soundness, a crisis of confidence exists, especially from rating agencies and capital markets.

Second, the energy trading derivatives business is complex, but it is a valuable industry for the nation. I need not tell this Committee how valuable derivatives have been for agriculture. Derivatives are no less important to the energy industry. The loss of a substantial portion of energy traders will ultimately have an adverse effect on energy prices as competition diminishes.

The third point that I want to make is that it is critical for bodies, such as this Committee, to work quickly to remove uncertainty from the markets, to make corrective remedies where warranted, and to allow the energy industry to get back to the business of building critically needed infrastructure. This is essential if we are to supply the reliable and competitively priced power necessary to the well being of American consumers and businesses.

Mr. Chairman, the entire energy sector has experienced a state of upheaval since the twin events of the California energy crisis and the Enron bankruptcy. The troubling effects of these events have expanded to affect all energy traders, even those who had nothing to do with either the California market or Enron's inappropriate practices. My company withdrew temporarily, but significantly, from the California market in the fourth quarter of 2000, because we saw signs of instability in that market. As a result, the level of risk to participate was too high. Moreover, we did not engage in the kinds of improper accounting or trading practices for which Enron has

become notorious. We played by the rules. Yet we were swept up in the same wave of uncertainty and lack of confidence that has resulted in credit downgrades and investor flight. Consequently, a substantial portion of the trading industry has reduced their trading activities or withdrawn altogether.

The Commodities Future Modernization Act of 2000 was a significant step forward for financial market development in the U.S. Its primary act was to provide legal certainty for the over-the-counter or "off-exchange" derivative markets. Congress provided the legislation necessary to enable companies to actively engage in transactions with derivative products, to manage their price risk, and to provide stability in their business.

Frankly, we at Aquila do not believe that the current Commodities Futures Modernization Act led to the crisis in this industry. We are not sure that one can put the responsibility on the wording of any specific Federal law. We believe that the Act gave ample authority to address fraud and market manipulation. However, we are here to decide whether the current law should be modified, given the current situation. We believe that restoration of public confidence in this industry does require revision in the current law.

The current business climate, not just in energy, is frankly, perilous. The difficulties are both structural and psychological. Starting with the California energy crisis, then Enron, Arthur Anderson, Tyco, Xerox, Qwest, and now WorldCom, the country as a whole has become distrustful about business ethics, financial reporting, accounting practices, and the use of financial instruments such as derivatives. Companies have gone out of their way in annual reports to state that they don't use derivatives. Credit agencies, in response to the Enron collapse, are exercising heightened scrutiny of companies using business practices that were

perfectly acceptable only a quarter ago. This heightened scrutiny has led investors to flee investments in companies that operate in complex industries or who use these financial products.

You have a right, and perhaps an obligation, to ask, "Does the activity of these energy traders add value to the market? Do energy derivatives matter?

The answer is "yes". Derivatives have been shown to be a critical factor in investment and growth of the economy.

By utilizing futures, options, and swaps, Aquila and companies like it, are able to take price risk from someone who doesn't want it and distribute it to someone who will accept it. The use and value of derivatives in the energy industry is no different than the more "mature" industries like agriculture and banking. And, Mr. Chairman, this Committee is quite familiar with the importance of derivatives for agriculture.

Here is an energy industry specific example: Aquila has customized a derivative product called Guaranteed Bill for the customers of a midwestern regulated utility. Guaranteed Bill is marketed to residential customers by the local regulated utility. The service offers customers a fixed monthly bill for natural gas. It is designed to put the retail customer in control by allowing the customer to "fix" energy costs.

Historically, a customer trying to control costs was limited to a level payment plan that offers no insulation from weather or commodity price fluctuations, but only averages the monthly payments with a "true-up" over the course of the agreement. With Guaranteed Bill, there is no end-of-agreement "settle-up" payment due at the termination of the agreement. Aquila provides

the utility with a weather hedge and a fixed commodity price allowing the utility to provide its customers with true price certainty.

Another example of the benefits of a customized derivative is our contract with the Sacramento municipal utility which provides them power or cash to purchase power when there is insufficient rainfall for their hydroelectric generation to operate. This allows the Sacramento utility to protect its customers from rate increases to cover the cost of purchasing last minute power at high prices on the open market during periods of drought.

From an infrastructure perspective, the PJM Regional Transmission Organization, which operates in the Pennsylvania, New Jersey and Maryland areas--has received stakeholder approval of market changes that will boost the use of hedging instruments to manage the risk of congestion. PJM is arguable the most effective RTO in operation today.

By utilizing these risk-mitigating products, companies are able to precisely manage risk based on the business conditions they face and then to pass that savings on to their customers.

Chairman Greenspan in April of this year spoke to the Institute of International Finance. He stated, "*The performance of these increasingly complex financial instruments, especially over the past couple of stressful years, has been noteworthy. These financial products have contributed importantly to the development of a far more flexible and efficient financial system—both domestically and internationally—than we had just twenty or thirty years ago.*"

While Chairman Greenspan was speaking primarily of financial derivatives related to interest rates, the same can be said for the use of these instruments in the energy markets. These

instruments operate in the same way. One hedges price risk in interest rates or corn, another in natural gas. In one industry, this is rewarded. It should not be penalized in another.

That is why I believe that the current state of affairs in energy trading and the lack of understanding regarding energy derivatives is temporary. Let me say again, energy traders are simply too essential for competitive pricing, and derivatives are too valuable for risk reduction, not to be utilized again.

Primarily to restore confidence in this industry, this Committee must work quickly to put remedies and safeguards in place, where necessary.

Mr. Chairman, we at Aquila especially appreciate Senator Feinstein's willingness to listen to industry concerns throughout this process. We are certainly supportive of the principles of S. 1951 that create greater access to information for review and oversight by the appropriate governmental agencies. These principles are critical towards restoring public trust. Based on the latest version of her bill we are pleased to say that we can now support her legislation. These proposed changes in current law will:

(1) increase transparency through better and more detailed reporting of transaction data;

(2) give the appropriate regulatory agencies abundant and unambiguous authority to investigate anti-fraud and anti-manipulation tactics that have been so critical in destroying investor confidence; and

(3) require for bi-lateral dealer markets the use of Value-at-Risk models, or in very limited circumstances and where the Commission determines the risk demands it, the application of minimum capital requirements.

> It is important for all corporate citizens to support these provisions. It is through more openness and accountability that we can we start the task of rebuilding America's confidence in the energy trading industry.

Nevertheless, this proposed legislation will only speak to the CFTC's authority over financial transactions in energy. It is also important that issues regarding restructuring, capitalization, generation, transmission and standard market designed are fast-tracked and addressed in a similarly aggressive and direct manner as the derivative legislation.

In testimony before another Senate Committee, Aquila has urged the Congress to reaffirm FERC's authority to:

- Move forward on broad, regional transmission organizations (RTOs) to provide for more transparency.
- Adopt standardized interconnection rules to allow clear and timely access to the power grid for new generation supply.

In summary, the Enron debacle has led rating agencies to lose confidence in the energy trading industry for the time being. Yet energy trading and energy derivatives remain valuable tools for our economy, just as their agricultural counterparts are essential to that sector. This Committee and others in the Congress can help restore confidence through revisions and improvements in existing law. I am very pleased to work with Congress in whatever way Aquila can be helpful to restore that confidence.

Thank you for the opportunity to appear before the Committee and to testify on these important issues. I am happy to try to answer any questions you may have.

DOCUMENTS SUBMITTED FOR THE RECORD

JULY 10, 2002

Opening Statement of Senator Blanche Lincoln
Hearing on Energy Derivatives
July 10, 2002

Mr. Chairman:

- Thank you for holding this important hearing today.
- Recent revelations about problems at some of the largest corporations in the country highlight the need for Congress to take a look at how corporate America is doing business.
- The public concern with corporate accountability is growing and gaining momentum - from the first revelations about the Enron fiasco to the latest reports of accounting problems at places like WorldCom - and it threatens to affect the health of our vulnerable economy.
- The fears start at home with shaken investor confidence and spread abroad.
- Our trading partners have been talking about the need to strengthen corporate governance all spring.
- Clearly, Congress must take a look at what's going on, and determine what role, if any, we should play.
- That's what is behind the accounting reform bill, a bill I support.
- And it, in part, has given a sense of urgency to our consideration of the energy derivatives market.
- I agree that we should investigate the energy markets.

- Senator Feinstein has shown great leadership for her state by pushing the Senate to investigate the manipulations by some bad actors in the energy markets - Enron clearly among them.

- Yet, as we look at the broad range of financial instruments and risk management tools businesses use, I also want to urge some caution.

- Less than two years ago, Congress completed an exhaustive overhaul of the old Commodity Exchange Act, including a close scrutiny of the over-the-counter derivatives markets and also of the proper regulatory structure for electronic trading facilities.

- The four regulators that made up the President's Working Group, who are the primary regulators of these markets - the CFTC, the SEC, the Federal Reserve, and the Treasury Department - assisted our efforts and played an integral role in creating the Commodity Futures Modernization Act of 2000.

- Overturning this exhaustive work should only be done after careful analysis of the effects any revision to government oversight would have on these important markets and market participants.

- It was this concern for caution that led me to oppose Senator Feinstein's amendment to the Energy Bill earlier this year.

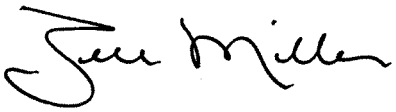
- At that time, I felt we should undertake a new round of hearings before we embarked on any changes to the CFMA.

- So, I thank the Chairman and also Senator Feinstein for the work to make these hearings happen, so that this body can undertake this new look at these issues in a careful and deliberative manner.

- I thank our witnesses today, most notably our distinguished

colleague from California, Senator Feinstein, and I look forward to their testimonies.

Statement: Derivative Hearing



Mr. Chairman

I want to thank you for holding this hearing. On March 5, Senator Crapo and I asked you and Senator Lugar to hold this hearing in order to give the agriculture committee and all Senators a clearer understanding of energy derivatives' trading and the potential negative impacts that could result from legislation being considered by the Senate. My sense is that this hearing could become the first of several hearings on these issues as we see how the energy problems unfold and once the various regulatory agencies have a chance to look at the problems.

Last March 7th, Chairman Greenspan came before the Senate Banking Committee and I asked him "if he had any thoughts on the impact of derivatives on energy prices during the California energy crisis." Chairman Greenspan said, "You don't need derivatives to explain what happened to prices[in California]. It is conceivable that there may have been price manipulation. There may have been a number of things. But I don't think that you need to advert to derivatives ...to explain what happened [in California]." I am sorry Chairman Greenspan is not with us today because he gave me a wonderful economic overview at that time. He said that California initially had electricity capacity buffers and they were trying to keep prices down... no new plants came on stream and the buffer disappeared and California ended up with price inelasticity so they had to raise the retail prices of power and demand came off fairly abruptly. It was a very interesting economic story.

I look forward to the testimony today. I am concerned that we will only hear one side of the story. I opposed the derivatives amendment back in March and although some changes have been made to satisfy a few, I still oppose it today. I do not see that anything has changed in the energy industry to require changes in derivative legislation. As for the energy industry, we need to see what the regulators find. But I am concerned that the amendment would have a far reaching and crippling effects on my state and the entire energy trading market.

I do believe this Hearing will be a good start in investigating whether the CFTC has all the legislative tools they need in developing the right approach to curb abuses in energy trading and financial reporting. Mr. Chairman I hope to work with you and the committee in pursuit of a solution that will not disrupt the success of honest companies, and most of all protect American consumers.

Jim Miller

Mr. Chairman

I have 4 letters from Treasury Secretary O'Neill, Federal Reserve Chairman Greenspan, Commodity Futures Trading Commission Chairman Newsome, and Mr. Harvey Pitt of the Securities and Exchange Commission that were sent to various Senators during the Feinstein Amendment debate, and I ask they be included with my statement.

April 8, 2002

Honorable Tom Daschle
Majority Leader
United States Senate
Washington, D.C. 20510

Honorable Trent Lott
Republican Leader
United States Senate
Washington, D.C. 20510

The Honorable Tom Daschle and the Honorable Trent Lott:

The Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, the Chairman of the Securities and Exchange Commission and the Chairman of the Commodity Futures Trading Commission oppose adoption of the Feinstein energy derivatives amendment. These expert financial regulators have stated that enactment of the amendment would be premature given the lack of opportunity for full review of the amendment by the relevant committees of jurisdiction, its implications for energy and other derivatives activity, and the absence of a determination that energy derivatives played a role in the collapse of Enron or the California energy crisis.

The undersigned organizations urge you to consider the views of the **Treasury, SEC, CFTC** and the **Federal Reserve** and **oppose Senator Feinstein's amendment** to S.517.

Sincerely,

American Electric Power
AIG Trading Group Inc.
American Bankers Association
ABA Securities Association
Aquila, Inc.
Association for Financial Professionals
Bank of America
The Bank of New York
Barclays Capital, Americas
Blackbird Holdings, Inc.
Citigroup
Coral Energy
The Bond Market Association
Credit Suisse First Boston
Duke Energy
Dynegy
Edison Electric Institute
Electric Power Supply Association
Entergy-Koch L.P.
eSpeed
The Financial Services Roundtable
FleetBoston Financial
Futures Industry Association
Gold Institute
Goldman, Sachs & Co.
Intercontinental Exchange
International Swaps and Derivatives Association
J.P. Morgan Chase
Koch Industries
Managed Funds Association
Merrill Lynch & Co., Inc.
Mirant
Mellon Financial Corporation
Morgan Stanley
National Association of Manufacturers
National Mining Association
PNC Financial Services Group, Inc
PSEG
Reliant
Royal Bank of Canada (NY Branch)
Securities Industry Association
Southern Company
Sun Trust
Tractebel Energy Marketing
Tractebel Power Development, Inc.
Tradespark
Tullett & Tokyo Liberty Inc.
TXU
UBS Warburg
U.S. Chamber Of Commerce
Wachovia
Weather Risk Management Association
The Williams Companies

cc: The United States Senate

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 11, 2002

The Honorable Michael B. Enzi
United States Senate
290 Senate Russell Office Building
Washington, DC 20510

Dear Senator Enzi:

Thank you for your letter concerning proposed amendment #2989 (*Congressional Record*, March 7, 2002, p. S1685), introduced by Senator Dianne Feinstein and others, to S. 517, the pending Senate energy legislation. This amendment would repeal key provisions enacted as part of the Commodity Futures Modernization Act (P.L. 106-534) applicable to over-the-counter derivatives contracts in certain energy products.

The Securities and Exchange Commission believes this legislative change is premature at this time -- barely more than a year after the CFMA's enactment. Because of on-going federal investigations, the lack of rigorous analysis about the CFMA's effect on the derivatives markets as a whole, and the absence of a determination about what role (if any) over-the-counter derivatives played in the collapse of Enron or the California energy crisis of last summer, we do not believe that any action should be taken until all of the facts are available for evaluation.

Thank you for giving the Commission an opportunity to comment on this legislative proposal.

Yours truly,

Harvey L. Pitt

Harvey L. Pitt

cc: The Honorable Christopher Dodd
The Honorable Paul Sarbanes
The Honorable Phil Gramm

U.S. Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581

James E. Newsome
Chairman

(202) 418-5050
(202) 418-5533 Facsimile

March 7, 2002

The Honorable Michael D. Crapo
United States Senate
111 Russell Senate Office Building
Washington, DC 20510-1204

The Honorable Zell Miller
United States Senate
200 Russell Senate Office Building
Washington, DC 20510-1006

Dear Senator Crapo and Senator Miller:

Thank you for your request to offer the Commission's position on Senator Feinstein's proposed amendment to the energy bill now being debated in the United States Senate. This proposed amendment would rescind significant advances brought about by the Commodity Futures Modernization Act of 2000 ("CFMA" or "Act"), which was signed into law by President Clinton just 14 months ago with unanimous support of the President's Working Group and overwhelming bipartisan support from the Congress.

To date, we have not found credible evidence to justify revisions to this law. However, at the appropriate time, we stand ready to assist the Congress in seeking any necessary and appropriate changes to our oversight authority that would advance our mission of protecting the public from fraud, manipulation, and abusive practices. As unfortunate as the Enron situation is, we believe that all the facts and evidence should be analyzed to identify potential problems before a solution is attempted. The Commission also notes that Congress is holding hearings inquiring into the events leading to the collapse of Enron, and that the Commission and other agencies are conducting independent inquiries as well. The Commission believes it would be premature to make any legislative changes prior to the completion of these inquiries. The Commission will share the findings of our inquiries into this important matter and any potential legislative recommendations with the Congress as expeditiously as possible.

Respectfully,

James E. Newsome
Chairman

March 12, 2002

The Honorable Trent Lott
United States Senate
Washington, D.C. 20510

Dear Senator Lott:

We are writing to express our serious concerns with an amendment to be offered by Senator Feinstein and others to S.517, the national energy policy bill. We are committed to ensuring the integrity of the nation's energy markets. However, we question whether it is necessary to re-open the Commodity Futures Modernization Act of 2000 (CFMA) to achieve that objective. Amending the CFMA as proposed by Senator Feinstein could re-introduce legal uncertainties into off-exchange derivatives markets and other markets – uncertainties that were thought to have been settled as a result of the CFMA's enactment.

Accordingly, we urge Congress to defer action on Senator Feinstein's proposal until the appropriate committees of jurisdiction have a chance to hold hearings on the amendment and carefully vet the language through the normal committee processes.

The CFMA expressly maintained the Commodity Futures Trading Commission's (CFTC) anti-fraud and anti-manipulation authority with respect to off-exchange energy derivatives markets covered by the Commodity Exchange Act (CEA). Thus, it appears that the CFTC may have sufficient current authority to address instances of fraud or price manipulation in energy derivatives markets. Congress should carefully evaluate the adequacy of the CFTC's current authority before it attempts to re-open the CFMA.

The CFMA was the culmination of a long, difficult process, which provided much needed clarification regarding the scope of the CEA for all off-exchange derivatives instruments, not just energy products. Any effort to undo the delicate compromises achieved in that legislation should be undertaken only after careful reflection. Otherwise, such legislation could jeopardize the contribution that off-exchange derivatives have made to the dispersion of risk in the economy. These instruments may well have contributed significantly to the economy's impressive resilience to financial and economic shocks and imbalances.

Similar letters have been sent to Senators Harkin, Lugar, Sarbanes, Gramm, and Daschle.

Sincerely,

Paul H. O'Neill
Secretary
Department of the Treasury

Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System

STATEMENT BY SENATOR PATRICK LEAHY

Mr. Chairman, I want to thank you and Senator Lugar for holding this hearing today to examine the Commodity Futures Trading Commission's (CFTC's) regulatory authority over markets in over-the-counter derivatives and to consider whether the CFTC's authority should be increased in order to prevent fraud and market manipulation. I also want to thank Senator Dianne Feinstein, and the other witnesses, for their appearance and testimony here today. I note that I am a co-sponsor of Senator Feinstein's bill.

The Commodity Futures Trading Commission (CFTC) was created in 1974 to, in part, regulate derivative financial markets. Today, however, most derivatives trading goes on outside the CFTC's jurisdiction. Two years ago, Congress passed the Commodity Futures Modernization Act of 2000 (CFMA), which brought about sweeping changes to the regulation of derivatives—both on and off exchanges—in the United States. The primary purpose of the CFMA was to exclude from CFTC's oversight transactions where most market participants were otherwise overseen as financial institutions by another federal financial regulator, such as the Federal Reserve Board, the Department of Treasury, or the SEC, thereby reducing the regulatory burden on an already well-regulated segment of the industry. The CFMA was intended to exempt from CFTA's general oversight of over-the-counter derivative transactions in certain exempt commodities, including energy and metals, while retaining the CFTA's anti-fraud and anti-manipulation jurisdiction over exempt commodities.

The CFMA allowed over-the-counter markets for energy derivatives to flourish. To some extent, it helped enable the Enron Corporation to become the nation's seventh-largest company, the world's largest buyer and seller of natural gas, and a favorite of Wall Street by becoming the country's leading electricity trader. But in the wake of Enron's sudden collapse and allegations of wide-spread manipulation of energy prices by Enron

and other energy companies in California and across the West Coast, we need to ask ourselves whether the pendulum has swung too far, and whether, and to what extent, CFTC's authority to regulate derivate trading in the energy sector and other sectors should be restored.

Enron's collapse and the subsequent revelations about its business practices revealed what I believe to be a significant "regulatory gap" that left West Coast energy consumers—and investors across the nation—unprotected. Only months before Enron's bankruptcy filing in December 2001, the firm was widely regarded as one of the most innovative, fastest growing, and best managed businesses in the United States. With the swift collapse, shareholders, including thousands of Enron workers who held company stock in their 401(k) retirement accounts, lost tens of billions of dollars. Enron's trading partners and lenders suffered significant losses as well. It now appears that Enron was in terrible financial shape as early as 2000, burdened with debt and money-losing businesses, but manipulated its accounting statements to hide these problems. And yet the watchdogs didn't bark—the investing public and other energy traders had no warnings that something was amiss.

The collapse of Enron has become a symbol of a corporate culture where greed has been inflated and accountability devalued. Unfortunately, Enron is no longer alone. It seems that every week brings news of a new financial scandal and stock markets sinking lower and lower. Joined by Arthur Andersen, Global Crossings, Tyco, Xerox, ImClone, and most recently WorldCom, Enron's apparent actions have shaken confidence in our financial markets.

We must act now to restore confidence in the integrity of our markets and to hold those who defraud investors accountable for their crimes. In April, I introduced S. 2010, the Corporate and Criminal Fraud Accountability Act, which was designed to restore accountability and transparency to our financial markets by punishing and preventing fraud, preserving the evidence of fraud, and protecting victims of fraud. Yesterday, Senator Daschle, Senator McCain and I offered S. 2010 as an amendment on the

accounting reform bill. I hope the Senate will vote on it later today—and hopefully, the vote will be unanimous, as it was when the bill was reported favorably by the Committee on the Judiciary. This bill is supported by law enforcement, regulators and numerous whistleblower and consumer protection advocates. It is going to send wrongdoers to jail and save documents from the shredder, and that sends a powerful and clear message to potential wrongdoers – "don't do it." As I have said before, we cannot stop greed, but we can stop greed from succeeding.

In addition to ensuring that bad actors pay a price, we need to make sure that the system of oversight, review, and monitoring of markets is sound in order to prevent these things from happening in the first place. We need to learn from the past and close the regulatory loopholes we know exist.

Even if derivatives trading was not a major cause, Enron's failure raises the issue of supervision of unregulated derivatives markets. Would it be useful if regulators had more information about the portfolios and risk exposures of major dealers in derivatives? Of course. Although Enron's bankruptcy appears to have had little impact on energy supplies and prices, a similar dealer failure in the future might damage the dealer's trading partners and its lenders, and could conceivably set off widespread disruptions in financial and/or real commodity markets.

I understand that the Federal Reserve, the Department of the Treasury, and others have maintained that the multi-trillion-dollar global market in over-the-counter derivatives—which are traded outside commodity exchanges—should continue to be exempt from regulation. Although I may agree that markets for financial derivatives are adequately regulated, I don't believe this is true for other markets—namely, markets for energy and metal derivatives. That's why I decided to co-sponsor Senator Feinstein's bill to restore the CFTC's authority to regulate non-financial over-the-counter derivatives transactions.

Senator Feinstein's bill would give regulatory authority to the CFTC over all derivative transactions of energy and metals commodities and ensure that all these transactions are transparent. Non-commodity financial derivatives would not be regulated under the terms of the bill. It would ensure that electronic exchanges that trade energy derivatives be subject to similar requirements as other exchanges, like the Chicago Mercantile Exchange, the New York Mercantile Exchange and the Chicago Board of Trade. In addition, those who trade energy derivatives off an exchange would be required to keep a record of their transactions. That way, if there is a complaint, the federal regulators would have a record to review. The modest, common-sense reforms embodied in Senator Feinstein's legislation would address the essential concerns about the integrity of the market place and help restore consumer and investor confidence in our economy.

Testimony of
Pat Wood, III
Chairman, Federal Energy Regulatory Commission
Before the Committee on Agriculture, Nutrition and Forestry
United States Senate
July 10, 2002

/Ir. Chairman and Members of the Committee:

Thank you for the opportunity to submit testimony on regulation of over-the-ounter derivatives and whether additional oversight of these derivatives is needed to revent fraud and market manipulation. I am not an expert on derivatives or the existin; egulatory authority of the Commodity Futures Trading Commission (CFTC). Thus, in ıany respects, I will defer to the testimony of the other witnesses on these issues. Iowever, as Chairman of the Federal Energy Regulatory Commission (FERC), I will ffer my perspective on regulatory oversight of energy-related derivatives and its effect romoting transparency, stability and confidence in energy markets.

The attention now being paid to energy-related derivatives began with two major rises. The first was the energy crisis in California and Western States. In May 2000, rices for wholesale electricity in the West increased significantly. Later that year, price ɔr natural gas in the West also increased significantly. Energy prices stayed at extremel igh levels for over a year, finally subsiding in Summer 2001. The total cost to ɔmpanies and customers in these States was enormous. Many factors, including an nbalance of supply and demand, appear to have contributed to this crisis, and the lack c ansparency has hindered the ability of the market (and public policy makers) to make a mely assessment of the problems.

The second crisis was the collapse of Enron Corporation. Late last year, :counting irregularities at Enron, and the resulting loss of stockholder confidence in the ɔrporation, forced Enron into bankruptcy. Investors and employees lost billions of ɔllars, and thousands of employees lost their jobs.

Subsequently, some alleged that Enron had been using its role as the nation's rgest energy trader to manipulate wholesale energy prices, through derivatives and herwise. FERC's staff is now investigating whether wholesale energy markets were anipulated by Enron or other sellers and, if so, the effect of such manipulation on arket prices. In investigating these issues, FERC's staff is working with staff from the FTC, leveraging each agency's strengths in its sphere of expertise.

More recently, other energy companies have disclosed "round-trip" trades. These isclosures have further eroded confidence in wholesale energy markets.

In response to these developments, a number of energy companies have reduced liminated their trading operations. Others have stopped or delayed construction of ower plants, for lack of capital or to strengthen their balance sheets. In the short term, ıe loss of confidence in energy markets is hurting energy companies; but, in the long erm, the decline of investment in energy production and infrastructure will hurt energy ustomers across our Nation.

One way to improve confidence in these markets is to enhance transparency. nergy customers, investors and regulators should have access to the broadest range of seful market information. Information on financial as well as physical transactions is a ey part of market transparency. Billions of dollars are now at stake in energy markets. reater transparency can help FERC and financial market regulators and players to bette ıonitor individual companies' participation and diminish the ability of any individual layer to misbehave or misrepresent in the marketplace.

FERC has taken steps to improve transparency in energy markets. For example, ERC has improved its reporting requirements to ensure that prices for all wholesale ower trades are reported to FERC (and, ultimately, the public) in a "user-friendly" lectronic format. However, to date, FERC generally has asserted jurisdiction only over holesale power transactions that involve physical delivery of electricity, not over nancial transactions involving energy-related derivatives. FERC does not have any irect authority under the Federal Power Act or the Natural Gas Act over energy-related erivatives.

Legislation has been proposed by Senator Feinstein and others to enhance gulatory oversight of energy-related derivatives by the CFTC. I have previously stated at federal oversight of such trading is appropriate, and that effective oversight over itical energy derivatives can ensure greater transparency and provide an early warning gnal to those charged with protecting the public interest. Disclosure of relevant formation regarding such transactions would complement the FERC's recently-adopted porting requirements, which are having the unintended (but welcome) benefit of oviding comparable and substantive market data necessary to evaluate various aspects the power business. This improves confidence in markets.

Adequate oversight is vital to restoring stability and confidence in energy market ınd will benefit energy customers over the long term. It is critical for customers to have ccess to the broadest range of useful market information to make informed decisions bout energy choices.

As always, I will be happy to provide any further information you may need and ffer the services of my colleagues and staff to the Committee's efforts.

Thank you.

Testimony of James M. Falvey

Vice President, General Counsel

IntercontinentalExchange, Inc.

before the

Committee on Agriculture, Nutrition and Forestry

United States Senate

Transparency and Oversight of Energy Derivatives

Introduction

On behalf of IntercontinentalExchange, Inc. ("Intercontinental" or the "Company"), I want to thank the Committee for the opportunity to submit this written testimony into the record for its consideration.[1] By way of brief background, I am the General Counsel at Intercontinental and, as such, am responsible for all legal and regulatory affairs of the Company. Prior to joining Intercontinental, I was a Director and Associate General Counsel at the Chicago Mercantile Exchange. Thus, I have had the opportunity to work in and observe first hand the regulated futures market, as well as an over-the-counter marketplace.

I would initially note that there has been much confusion in the public as to what IntercontinentalExchange is, and how we operate. Intercontinental was formed in May 2000 by Jeffrey Sprecher, who pulled together a group of investors that included various large banks and oil companies. Thereafter, this group was expanded to include six power and gas trading companies.

IntercontinentalExchange is a web-based platform for over-the-counter ("OTC") trading in global energy products. The first trade on our platform occurred in August 2000 in global precious metals. Trading in OTC global oil and North American natural gas and power (electricity) commenced in October 2000.

In June 2001, Intercontinental purchased the International Petroleum Exchange ("IPE"), a UK Recognized Investment Exchange, which is regulated by the Financial Services

[1] We understand that Senator Fitzgerald inquired at the hearing on July 10, 2002 as to why no representative from IntercontinentalExchange had appeared before the Committee. The simple answer is that we weren't invited to the hearing. Nonetheless, we appreciate the Committee holding open the record for this submission. Furthermore, we would welcome any future opportunities to discuss these important issues with the Committee.

Authority in London. The IPE performs the role of frontline regulator for its markets and has its own market surveillance, investigations and disciplinary procedures. We are working with the IPE to take the first of this exchange's products electronic in the third quarter of 2002.

We have continued to expand the portfolio of products offered on our system for trading to meet our customer's needs. Currently, besides global precious metals, global oil, North American natural gas and power, we offer trading in North American weather derivatives, emission credits, coal products and European natural gas and power. These products include the spot, or cash market, as well as various derivative instruments.

As noted above, our trading system is a web-based platform. All of our users, who are Exempt Commercial Entities ("ECE") under the Commodity Exchange Act ("CEA"), have equal access to our system through the Internet (or, if a user so desires, it can access our system through a Virtual Private Network – or "VPN" solution). Any user can post a bid to buy or offer to sell in any market in which it chooses to participate. All of our users have access to all of the bids and offers that are posted in a given market. While our system resembles an electronic bulletin board for auctions (not unlike eBay), we do utilize a price-time priority algorithm to determine the order of which bids are hit or which offers are lifted. In order words, the best bid or best offer will always be required to be selected. If there is more than one best bid and/or offer, then the time that the order was entered will determine which bid and/or offer is hit first.[2]

Approximately 630 companies have access to our system. These entities can only trade for themselves (i.e., there is no brokering on our system). Within these 630 companies, there are approximately 9,500 individual traders with access to our system. On an average day, approximately 3,500 of these traders will utilize our system either to engage in trading activity or to view the market to seek price information.

We do not currently charge any entity for access to our system. Our revenue comes from commission fees, similar to a brokerage operation. We do not participate as a principal in trading activities.

Our Regulatory Structure

Contrary to what has been reported in the media, and some of the testimony before this Committee, Intercontinental does not fall into a regulatory "neverland" or "black hole" created by passage of the Commodity Futures Modernization Act ("CFMA"). Quite the contrary, prior to passage of the CFMA, Intercontinental applied for and received a "no-action" letter from the Commodity Futures Trading Commission ("CFTC") that, despite the moniker, placed an obligation on us to disseminate price information for our most liquid markets and reserved the CFTC's right to, among other things, access our books

[2] Our system does allow participants to control their credit risks with one another. As such, unless participants have credit established with each other – which is set by a credit/risk manager within the company's back office, the trader cannot set credit herself – they cannot trade with each other. Thus, a trader can only hit a bid or an offer in which they are credit enabled.

and records. This CFTC oversight was enhanced and formalized by passage of the CFMA under which we became an Exempt Commercial Market ("ECM"). See Section 2(h) of the CEA. In this capacity, we are subject to a variety of legal requirements. Among other things, we are required to:

1. file a notice with the CFTC giving basic information (name, address, commodities to be traded, etc.), identifying any clearing organizations that will provide clearing services, and representing that none of the our senior management personnel is subject to disqualification under the CEA and that the ECM will notify the CFTC of any material changes;

2. provide the CFTC with access to our trading protocols and electronic access to our trading facility;

3. provide to the CFTC such reports regarding trading on Intercontinental as the CFTC may request;

4. maintain for five years, and make available to the CFTC, information sufficient to allow reconstruction of trade data and the name and address of each participant;

5. provide information to the CFTC, upon its request, regarding our status as an exempt market;

6. notify any foreign person trading on the facility of any subpoena issued by the CFTC to such person and transmit the subpoena to such person and, if the CFTC so directs based on a reasonable belief that the person has not complied with such subpoena, limit trading by such person or deny such person trading privileges;

7. impose on each participant a requirement that it comply with applicable law in connection with its trading activities; and

8. have a reasonable basis to believe that each participant's legal representation that it qualifies as an eligible participant is accurate.

Id.

Additionally, Intercontinental's marketplace is subject to the anti-fraud and anti-manipulation jurisdiction of the CFTC. Id. Finally, Intercontinental is subject to a price reporting requirement under the CEA. Specifically, if the CFTC determines that one of our markets has become the source of significant price discovery, it can require us to provide that data to the public.

Accordingly, Intercontinental is subject to the general jurisdiction and oversight of the CFTC, and the CFTC has certain authority over it, as well as the participants that trade on the system. Notably, as an ECM, Intercontinental is by statute not allowed to indicate

that it is regulated by the CFTC, although it is certainly subject to oversight by the CFTC. Given the fairly lengthy list of regulatory and legal requirements above, we would submit that Congress did a disservice to ECMs in the Commodity Futures Modernization Act by limiting their ability to state that they are, in fact, generally regulated. We believe that this statutory limitation, along with the unfortunate name given to us – EXEMPT Commercial Market – has led to much of the confusion about our marketplace.

Significant Differences Between Intercontinental and Enron/EOL

Given that Intercontinental is an electronic marketplace where energy products are traded, we have been thrown in the same bucket with Enron and/or Enron Online ("Enron") by certain entities. Nothing could be further from the truth. There are significant differences between Intercontinental and Enron, including:

Enron	IntercontinentalExchange
Largest trading firm	Does not trade at all; simply a broker; never a counterparty
Dominant price-maker	Has no role, ability or interest in determining market prices
Made money by realizing bid/offer spread and other trading profits	Makes money from brokerage and confirmation fees, and potentially market data sales (regulated exchanges typically receive 20- 30% of their revenue from market data sales)
No obligation to serve customers equally or at all	Any ECM can request and receive equal access to Intercontinental (including equal access to information)
Single counterparty system (one to many)	Multi-counterparty system (many to many) with optional clearing services
No transparency	Depth of market; real-time ticker; high/low/last/average for any timeframe available to all users
One of more than 630 ICE Participants	No reason or standing to have access to EnronOnline or be a customer of Enron

Transparency

Certainly, one of the primary criticisms of Intercontinental has been an alleged lack of transparency of our marketplace. Again, we believe that this criticism has resulted from misinformation about Intercontinental. We are a very transparent marketplace, and, in fact, plan on offering an additional array of market data products in the very near future.

Notably, prior to the arrival of our platform – generally two years ago – the energy OTC marketplace was extremely opaque. In order to receive any pricing information whatsoever, a trader would need to call a broker or counterparty and request such information (or subscribe to a newsletter that was based on limited information generally gathered from an unscientific survey substantially after the fact).

Among other things, on our platform:

-- All participants on Intercontinental's system have equal access to the same market data information. That is, up to 9,500 users can see a wide variety of data -- all bid/offers/last trade/high/low and average – for all of our markets. This real-time information is currently provided free of charge to all of our participants (ECMs).[3]

-- Since July 2001, we have published daily North American Gas and Power cash indices, which are audited for accuracy by Ernst & Young. These indices are available to anyone in the world published via our website. Historical information is also available (to access, simply go to: www.intcx.com; hit "services," then "price indices").

-- On July 9, 2002, we began publishing daily North American Gas and Power price alerts that provide a snapshot of price indices that represent a volume weighted average of price activity on our platform during the course of the morning's trading activity, as well as a comprehensive snapshot of all spot and forward pricing activity on the platform during the course of the trading day. Currently, this information is available to anyone through our website. The publication of this information is unprecedented in the energy OTC marketplace.

-- We are currently in the process of preparing to provide a subscription service of all of our North American Gas and Power pricing.

-- As noted above, as an ECM, Intercontinental is subject to the price discovery provision in the CEA, Section 2(h)(4)(D).

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[3] At some point in the future, our business plan calls for us to charge for this data. Again, this proposal is consistent with the regulated futures exchanges that, as noted above, typically receive approximately 20-30% of their revenue from market data sales.

-- The CFTC, FERC and the UK Regulator, the FSA, have all had access to real-time Intercontinental data (real time ticker) and have had this since trading began on the system.

Conclusion

Again, I want to thank the Committee for this opportunity to present this testimony. We look forward to working with the Committee on this very important issue.

RE: Wednesday's Agriculture Committee Hearing on CFTC and Derivatives

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July 9, 2002

The Honorable Tom Harkin
Chairman
Senate Committee on Agriculture, Nutrition and Forestry
Room 328A Russell Senate Office Building
Washington, DC 20510

Dear Chairman Harkin:

Tomorrow, your committee will be holding a hearing on CFTC Regulation and Derivative Oversight. We are writing to express our concern about possible alterations in the regulation of energy derivatives.

EPSA is the national trade association representing competitive power suppliers, including independent power producers, merchant generators and power marketers. These suppliers, which account for more than a third of the nation's installed generating capacity, provide reliable and competitively priced electricity from environmentally responsible facilities serving global power markets. EPSA seeks to bring the benefits of competition to all power customers.

We welcome this hearing, and we believe that this is an excellent opportunity to investigate how derivatives operate and what the current level of regulatory oversight is. EPSA supports effective, functioning energy markets, and we believe that derivatives are an important segment of these markets. As participants in derivatives markets, we are deeply concerned with ensuring that these markets are efficient, fair, and free from manipulation and other anti-competitive activities.

We support the efforts of Congress and the Administration to identify and resolve any problems which may exist in energy trading, but we urge you not to alter the current regulatory framework until your committee and regulatory agencies – including FERC, the CFTC, the SEC, the Treasury Department and the Federal Reserve Board – have clearly identified the real problems, clarified any need for change and outlined how to achieve it.

We remain concerned about the possible effects of Senator Dianne Feinstein's bill to increase regulation of derivatives – S. 1951 – and we urge you to consider fully what consequences this bill may have. Energy markets have developed as a result of a quarter century of regulatory and legislative action culminating in the Commodity Futures Modernization Act of 2000 (CFMA). Through the CFMA, energy companies have been able to effectively reduce financial risk posed by volatile energy commodities through a variety of financial instruments known as derivatives. The CFMA – which was unanimously adopted in the Senate – provided legal certainty on the trading of energy derivatives, which allow electric generators to effectively moderate volatile energy prices

RE: Wednesday's Agriculture Committee Hearing on CFTC and Derivatives

and optimize the output of their generating plants. As a result, consumers have benefited through lower electric and gas rates.

There is no evidence that energy derivatives transactions contributed to price spikes, supply disruptions or any other market dysfunctionality in the west or elsewhere. In fact, one of the unambiguous lessons from the west is that all market participants should reduce electricity price risk through instruments like energy derivatives. We believe that existing laws already provide CFTC oversight of energy trading, including oversight responsibilities of electronic trading platforms, to prevent against manipulation of energy markets.

The legal uncertainty created by S. 1951 may hurt consumers by hampering the effectiveness of financial markets to reduce price volatility and financial risk. Today's Wall Street Journal highlighted the problems caused by decreasing liquidity in energy markets, and illustrated one of our chief concerns – the possibility that trading could be driven away from electronic platforms, thereby decreasing market efficiency and making markets less transparent and more volatile.

We look forward to continuing to work with your committee and Senator Dianne Feinstein to address the problems confronting the wholesale power markets.

Sincerely,

Lynne H. Church
President

cc: The United States Senate Agriculture, Nutrition and Forestry Committee
Senator Dianne Feinstein

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