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CHICAGO BOARD OF TRADE

BEFORE THE BANKING COMMITTEE OF THE UNITED STATES SENATE

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Mr. Chairman and Members of the Committee, thank you for the opportunity to submit this written testimony on behalf of the Chicago Board of Trade ("CBOT") for the record and for the consideration of the Committee. The CBOT also thanks and congratulates the Congress for the passage in 2000 of the Commodity Futures Modernization Act ("CFMA"). The CFMA provided for increased competition and legal certainty in the derivatives industry and reduced many unnecessary regulatory burdens that served only to increase costs for the investing and hedging participants in U.S. financial markets. Some of the goals and promises of the CFMA have not been fully realized, however. Dual regulation and inefficient margining have contributed to an environment that has inhibited the development of a robust single stock futures industry. Regulatory confusion may be keeping other innovations from the market. And an unfortunate court decision has been issued which, if not overturned, raises the specter of increased fraud.

FRAUD BY UNREGISTERED PERSONS OFFERING LEVERAGED FUTURES "LOOK-A-LIKE" CONTRACTS SHOULD BE ADDRESSED.

The influential Seventh Circuit Court of Appeals in Chicago has rendered an opinion which essentially does away with previously settled law setting out determining characteristics of a futures contract. *Commodity Futures Trading Commission v. Zelener* 373 F.3d. 861 (7th Cir. 2004). This decision provides a road map for unregulated commodity transactions that can be used to defraud those least able to defend against it.

The CFMA excluded from the coverage of the Act certain over-the-counter transactions that involve highly capitalized, sophisticated persons—defined in the CFMA as "eligible contract participants." These persons were deemed by the Congress to possess, or at least to be able to obtain, the acumen or expertise to engage in margined or leveraged transactions in commodities without the protection of Commission regulation. Congress continued to believe that persons who did not meet the criteria for becoming eligible contract participants still needed the protection of federal regulation by the Commodity Futures Trading Commission ("CFTC") if they dealt in commodity futures.

When the CFMA was enacted and for four years after that, there was relative certainty as to what constituted a futures contract. For twenty-two years, the decision in *CFTC v. CoPetro Marketing Group, Inc*., 680 F.2d 573, 577 (9th Cir.1982) provided the means for the Commission, the industry and the courts to determine whether a financial transaction that could be used for leveraged or margined speculation on the prices of commodities was a futures contract. Using a "totality of the circumstances" test, the Commission and the courts could effectively deal with persons who offered speculative contracts involving commodities without proper registration.

Registration and the capital requirements found in Commission regulations acted to ensure that persons who offered futures contracts to the public had a large enough financial stake that they would not simply close up shop and disappear with their customers' money. Commission regulation and capital requirements essentially provided a credit and background check on such firms, which individuals and smaller entities, i.e., persons who are not eligible contract participants, lack the resources or ability to carry out for themselves.

When fraudulent dealings in commodities came to the attention of the Commission, typically the perpetrator was not a Commission registrant. The CFTC could immediately shut the operation down because the unregistered person was not permitted to offer or solicit orders for futures contracts because of the lack of registration. By moving quickly, and without first having to show all the requisites of fraud, the CFTC frequently could catch wrongdoers off guard and prevent them from hiding or otherwise further dissipating the assets of those who had been defrauded.

These federal protections for persons who are not eligible contract participants, along with the ability of the Commission to bring enforcement actions in appropriate cases, are no longer available against those who commit fraud using the form contract deemed not to be a futures contract in *Zelener*. Persons who are not eligible contract participants, i.e., those who Congress believed in 2000 still needed the protection of federal regulatory jurisdiction, are now protected only by the threat of after-the-fact legal actions by local prosecutors under the laws of the individual states.

The fundamental weakness of this approach was clearly demonstrated in the early part of the 1900s and lead to the enactment of the federal securities laws. In that era, persons who defrauded others in connection with the sale of securities were relatively safe from prosecution if they took care to cheat only persons located in another state. Local prosecutors in the state in which the criminal was located may have had little incentive to use their resources if the bulk of the victims were in other states, having more immediate and pressing needs in other areas; and prosecutors in states where the victims were located did not have jurisdiction over the person committing the fraud from another state. The Congress, according to Stephen M. Cutler, a former Director of Enforcement for the Securities and Exchange Commission, addressed this problem by making investor protection one of the goals of federal securities legislation in 1933 and 1934. Congress, recognizing "the ability of scammers to 'take advantage of State boundaries,'" saw fit to establish the Securities and Exchange Commission as a federal presence to deal with the interstate nature of securities fraud.[1]

To further quote Mr. Cutler, but in the similar context of commodity fraud, "these concerns have a surprisingly contemporary sound to them." Current day wrongdoers use telephone, internet and television appeals to showcase their fraudulent "pitches" involving heating oil, gold and other commodities. The National Futures Association and the Commodity

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[1] See, Remarks of Stephen M. Cutler, Director, Division of Enforcement, Securities and Exchange Commission, at Washington University School of Law, February 21, 2003, on SEC website found at http://www.sec.gov/news/speech/spch022103smc.htm#footnote_5, citing Hearing on the Federal Securities Act, 73rd Congress, First Session, A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act (submitted for the record by the Department of Commerce) pp. 99, 101.

Futures Trading Commission try to monitor these websites and infomercials, but the advent of the *Zelener* opinion may leave them impotent in the face of flagrant fraud.

The *Zelener* case is not about only foreign exchange products. The contract the *Zelener* Court found to be outside the jurisdiction of the CFTC may just as easily be utilized by scammers to induce the unsuspecting to invest in other commodities. Unless checked by an amendment to the CEA overturning the *Zelener* opinion, such fraudulent operators could cause a scandal similar to those involving options on sugar and other commodities in the mid-1970s. Such a scandal could, as then, reflect adversely on the legitimate financial services and derivatives industry here in the U.S.

The Chicago Board of Trade hopes that Congress will enact an amendment giving the CFTC the power to shut these fraudulent operators down by showing that they are dealing in futures contracts without the required registration, before this activity results in the loss of hard-earned savings of citizens. We favor an amendment that would cover all margined or leveraged speculative commodities transactions entered into with persons who are not eligible contract participants. Merely providing enhanced anti-fraud authority that can be used only after a fraud has been foisted on the public is insufficient to effectively address the problem.

Some have questioned whether anything at all should be done, raising the possibility that someone's legitimate business may be somehow affected. A properly drawn amendment that restricts only those who deal with persons who are not eligible contract participants, along with the forward exclusion, the Treasury Amendment and the other provisions enacted as part of the CFMA, should not adversely impact the operations of any legitimate person or firm. Indeed, the industry carried out its business for years when the *Co-Petro* standard was in place, including the four years between the passage of the CFMA and the issuance of the *Zelener* opinion, and a return to the regulatory landscape of that period should not further restrict any legitimate firm. To the extent, however, that persons may believe that proposed language may infringe on their legitimate operations, we would hope that they would provide specific examples so that language can be crafted to alleviate those concerns while giving the CFTC the necessary tools to protect the investing public.

DUAL REGULATION POSES BARRIERS TO INNOVATION.

The CFMA provided much-needed regulatory relief to entities regulated by the CFTC and granted the Commission flexibility to deal with new ideas and technological advances, while at the same time retaining concepts of customer protection that are essential to our industry. In addition, the CFMA brought legal certainty to many products either by removing them from Commission jurisdiction or by establishing standards and procedures by which products can be and remain exempt from further CFTC regulation. The CFMA also allowed for the trading of security futures products for the first time. This legislation and its implementation by the Commission have seen many successes. While the financial services industry has benefited greatly from the reforms of the CFMA, the goal of the Congress of reducing regulatory barriers to innovation has not been achieved in at least two areas, however.

First, the CBOT asks that the Congress consider clarifying that the definition of narrow-based security indexes does not include indexes on fixed income securities, corporate bonds and other non-equity securities. The present definition creates a series of tests to distinguish narrow-based indexes from broad-based indexes. Unfortunately, these tests are only workable for indexes on U.S. equity securities, and index products based on non-equity securities do not implicate the same issues. However, the possibility that the definition could be interpreted to cover non-equity products has hampered development of such products due to confusion as to what regulations may or may not apply.

To illustrate this point, the CBOT, and I'm sure a number of other exchanges, have considered offering futures based on corporate bond indexes. While we do not believe such indexes were intended to be captured by the definition of narrow-based security indexes, current law is not clear on that point. Many such indexes, if the tests designed to distinguish broad- from narrow-based indexes were applied, would fall into the narrow-based index category. As such, futures on these indexes could then be assumed to be regulated as stock futures products, jointly by the CFTC and SEC. Given that corporate bonds are not subject to the same regulatory regime as equity securities, the underlying reason for applying these tests to equity security indexes does not exist for corporate bond indexes. We believe that futures contracts on these types of indexes – whether indexes of corporate bonds, municipal bonds or other securities - should be regulated by the CFTC just as all other non-equity security futures and broad-based security index futures are regulated. Clarification of the definition is an important issue that deserves to be addressed at this time.

Another issue the CBOT hopes Congress will consider is the margining regime for stock futures products. The CFMA constituted both the Securities and Exchange Commission and the CFTC as regulators of stock futures products. This dual regulation of stock futures products has been challenging to date and the growth of single stock futures in the U.S. has been anemic, at best. The inability, at least to this point, of the SEC and the CFTC to afford rational regulatory treatment of margining for these products continues to stymie further development of stock futures and other needed products.

Historically, the power to set margins for futures products was reserved to the exchanges. Congress recognized that futures margins were performance bonds, posted by both buyers and sellers of commodities for future delivery, to ensure the performance of obligations under the contract, especially if the price moved adversely to one's position. Because futures contracts were not assets, such as stocks, and because margins were not a credit function in the acquisition of an asset, exchanges typically set margin at levels designed to cover the risk of several days' price movement on a historical basis. The levels of margin, set as a dollar amount per contract rather than as a percentage of the price of the underlying product, could quickly be changed in the event of higher volatility in prices, in other words, increased risk. With the advent of more powerful data processing and sophisticated financial valuation models and techniques, this risk-based margining today can be applied more precisely to futures positions and even to whole portfolios, measuring the risk inherent in individual positions as affected by other positions within the same portfolio. Using risk-based margining across whole portfolios has provided participants in the financial markets with greater flexibility and efficiencies, while at the same time affording greater stability to the markets themselves.

The CBOT hopes Congress will facilitate the margining of stock futures as futures contracts, recognizing that the economic function of a futures contract is not to acquire ownership of the stock, but rather is to act as a hedging vehicle.

The Chicago Board of Trade, the oldest and one of the largest futures exchanges in the world, vigorously competes in the international marketplace. We ask the Congress, and this Committee, to remain cognizant of the continued need to reduce unnecessary regulatory complexities that tend to inhibit the ability of U.S. exchanges to compete effectively with their counterparts around the world. We also ask the Congress to give the CFTC the tools necessary to prevent peripheral scandals that have the potential of tarnishing the U.S. derivatives industry.

Once again, the CBOT thanks the Committee for this opportunity. If the Committee or Members have questions, the CBOT will be happy to provide answers and additional information.