Testimony of

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Mr. Chairman and members of the Committee, my name is Jim Newsome and I am the President of the New York Mercantile Exchange (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. We have been in the business for 135 years and are a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC).

On behalf of the Exchange, its Board of Directors and shareholders, I thank you and the members of the Committee for the opportunity to participate in today's hearing on "Growth and Development of the Derivatives Market."

Introduction

Futures markets provide important economic benefits. NYMEX energy futures are highly liquid and transparent, representing the views and expectations of a wide variety of participants from every sector of the energy marketplace. As derivatives of cash markets, they reflect cash market prices and as a result are used as a hedging and price discovery vehicle around the globe. The price agreed upon for sale of any futures contract trade is immediately transmitted to the Exchange's electronic price reporting system and to the news wires and information vendors who inform the world of accurate futures prices. In addition to continuously reporting prices during the trading session, NYMEX reports trading volume and open interest daily and deliveries against the futures contracts monthly. Transparent, fair and orderly markets are critical to the NYMEX's success as the most reliable hedging vehicle for physical transactions and financially settled Over-the-Counter (OTC) transactions.

A key attribute of these products is their leverage. For a fraction of the cost of buying the underlying asset, they create a price exposure similar to that of physical ownership. As a result, they provide an efficient means of offsetting exposures among hedgers or transferring risk from hedgers to speculators. The leverage and low trading costs in these markets attract speculators, who play a valuable role as liquidity providers enabling commercial traders to get in and out of the market as needed. As liquidity increases, so does the amount of information absorbed into the market price, leading to a more broadly based market in which the current price corresponds more closely to its true value.

Impact of the Commodity Futures Modernization Act

The Commodity Futures Modernization Act of 2000 (CFMA) was landmark federal legislation that provided legal certainty, regulatory streamlining, flexibility and modernization to U.S. futures and derivatives markets. It provided a reasonable, workable and effective oversight regime for the regulated exchanges, while enhancing the abilities of exchanges to compete in a rapidly changing global business environment.

Product innovations such as new platforms for trading futures and clearing OTC products are a direct result of the ability to respond to constantly changing industry demands. Market participants have benefited from more useful risk management tools, better use of technology, greater liquidity, more efficient pricing and better customer service. Trading facilities have been able to provide more alternatives in trading platforms, products and business models.

Most importantly, these major changes to the regulatory landscape have not compromised the integrity of the marketplace in any respect. Support for this notion is demonstrated by the routine reviews of NYMEX's self-regulatory programs conducted by the CFTC. Exchanges remain at the top-tier of CFTC regulation, subject to 18 core principles covering all aspects of exchange operations, including customer protection, financial integrity, market integrity, recordkeeping and conflicts of interest. Moreover, the NYMEX's Derivatives Clearing Organization is subject to 14 additional core principles. The core principles establish broad performance standards that must be met by the regulated entity, but gives the entity the flexibility as to how it complies with these standards.

NYMEX's Compliance Department ensures that the core principles are enforced and the Exchange disciplines violative activity by its members. The Department is staffed with highly experienced individuals and equipped with cutting edge technology to conduct market surveillance, trade surveillance and financial surveillance to monitor market activity for abusive behavior. Automated surveillance systems are used to detect market manipulation, wash trading, pre-arranged trading, trading ahead of customer orders and violations of position limits. Staff also monitors trading activity during volatile markets to determine if a participant's activity is disruptive or manipulative.

The CFMA did not diminish the regulatory oversight responsibilities of the CFTC. All exchange actions remain subject to CFTC review and oversight and enforcement action. It is the CFTC's responsibility to assure that all futures exchanges are enforcing their rules and remain in compliance with the core principles. As intended, the level of regulation established for designated contract markets is appropriate for the nature and participants of the markets. Therefore, the CFMA effectively insures the market and financial integrity of regulated futures exchanges.

Growth and Development of Energy Derivatives

It is well documented that, beginning in the late 70s, the introduction of deregulation dramatically increased the level of competition in the energy markets. This competition prompted the development of the first-ever exchange-traded energy derivative products. The success and growth of these new contracts attracted a broad range of new participants to the energy markets. The addition of new participants to the markets also led to the introduction of new and wider varieties of energy derivatives. Today, the NYMEX, other exchanges and over-the-counter markets worldwide offer futures, futures options, swap contracts, and exotic options on a broad range of energy products, including crude oil, fuel oil, coal, heating oil, unleaded gasoline, and natural gas.

The futures industry has experienced tremendous growth since the adoption of the CFMA in December 2000, a clear sign that the current regulatory regime is appropriate for these markets at this time. Trading volumes in 2004 for futures and options globally increased 300 percent over the 2000 volume levels. U.S. futures and options volume for the same timeframe increased over 200 percent. NYMEX's futures and options volume alone as of 2004 had increased over 50 percent since year 2000 volume levels. Individually, NYMEX's flagship futures contracts showed significant volume increases as well, including crude oil – up 43 percent, heating oil – up 34 percent, and gasoline – up 48 percent.

NYMEX keeps its markets available for trading after the close of the open outcry trading session through the internet-based NYMEX ACCESS® electronic trading system. With NYMEX ACCESS®, NYMEX is open virtually around the clock. Traders can log on from any internet-enabled computer almost anywhere in the world. The after hours electronic trading session allows traders to protect themselves against exposure to price risk overnight. Total annual volume for NYMEX ACCESS® in 2004 was a record 8,239,700 contracts, breaking the previous record of 5,880,455 contracts set in 2003.

The CFMA, in addressing legal certainty for OTC derivatives, also permitted the clearing of OTC derivatives transactions by regulated futures exchanges. End-users and merchant energy companies that were existing customers of the NYMEX asked the Exchange to develop the clearing of standardized OTC energy products. NYMEX ClearPort® was the result of this request. During the initial period, 25 contracts were launched and currently the NYMEX ClearPort® program comprises over 175 products in the electricity, coal, NatGas, oil and emissions markets. Today, over 30 per cent of total NYMEX volume comes through the NYMEX ClearPort® system. This sustained growth can be linked to the addition of OTC clearing to NYMEX's range of services offered, which allows energy companies to mitigate their credit risks.

Additionally, NYMEX's global expansion has recently included the addition of cleared futures contracts for Singapore Fuel Oil and clean petroleum products, and European Fuel Oil, Naptha and Gasoline. This new clearing service has restored confidence, transparency, and liquidity to the marketplace and has once again allowed the economic benefits of derivatives to benefit the marketplace as a whole.

Off-exchange contracts submitted to NYMEX for clearing are afforded the same protections available to other futures contracts. The clearinghouse provides market participants with protection against counterparty default and is backed by a $130 million guarantee fund and a $100 million default insurance policy. The advantages of doing business on a regulated market are now available to any business entity with credit or price exposure in the energy markets. The ability of energy companies to now mitigate their credit risk with cleared derivatives brings liquidity, transparency and market confidence back to the trading community.

As a result of the demand by customers to mitigate their counter-party risk through new clearing products, the parent holding company of NYMEX has recently launched a new exchange in London to trade Brent Crude oil via open outcry. Additionally, the Exchange has announced the creation of the Dubai Mercantile Exchange – DME. The DME will bring the mitigation of counter-party risk to new contracts that will be traded in the Middle East region. In Singapore, the NYMEX has begun to add liquidity to regional Fuel Oil contracts through the use of the existing NYMEX ClearPort® Clearing system. Combined, the global expansion of the NYMEX brings the ultimate level of counterparty protection, liquidity and transparency to derivatives and regulated futures contracts.

New investment opportunities in the form of mini energy futures are offered by NYMEX for its highly liquid crude oil and natural gas futures contracts. The contracts are 50 percent of the size of the standard contracts and are financially settled at the settlement price of the physical commodity futures contracts on NYMEX.

Recent Legislative Proposals

Volatility and high prices in crude oil, natural gas and gasoline futures contracts have triggered unwarranted criticism of NYMEX. While a significant amount of energy trading occurs in other forums, such as in the OTC market, on electronic facilities and on exempt markets, NYMEX is targeted largely due to its highly liquid and transparent markets. A new bill passed in the House two weeks ago, calls for an investigation of NYMEX by the Federal Trade Commission. The General Accounting Office currently is studying the CFTC's oversight of NYMEX and there is consideration of yet another independent study of NYMEX in the context of CFTC reauthorization. Misinformation spread by groups who do not understand the futures markets has led certain Members of Congress to draft legislation that potentially would roll back many of the significant advancements achieved under the CFMA. Generally, supporters of the legislation mistakenly believe that the bill will stop volatility and reduce prices of natural gas. A number of proposals have been discussed that would apply to only the NYMEX natural gas futures contract, including:

- Artificial price limits on natural gas futures contracts;
- A price limit that triggers an investigation of the market by the CFTC; and
- Prior CFTC approval for NYMEX rule changes that expand price limits beyond 8 percent of the prior day's settlement price.

Prices are market driven and must be allowed to find their true level consistent with market fundamentals. Artificial restrictions prevent futures markets from reflecting true market value and prevent the use of the market as a dependable hedge against price volatility. In addition, artificial restrictions in the marketplace would result in:

- Greatly reduced (if not completely eliminated) price transparency;
- Higher costs;
- Higher price volatility—in the off-exchange market where price transparency is at the discretion of market participants subject to their parochial business interests; and
- Other classic symptoms of artificial price controls, such as government induced shortages.

Without NYMEX as a price discovery market, conducting business in the cash market will be severely impaired. Higher costs to do business quickly translate into higher prices for consumers.

The threat of investigative action each time a price limit is hit potentially would have a chilling effect on the markets. Moreover, the CFTC should have the flexibility to use its limited enforcement resources in the areas deemed most protective of the public interests.

Finally, NYMEX does not believe that the rule amendment process established under the CFMA for futures exchange products, other than agricultural commodities, should be repealed for one commodity on one exchange. There is clear evidence that the rule self-certification process has been a huge benefit to exchange growth and development without indications to date of regulatory risks.

Conclusion

Five years ago, Congress took a giant step in revising the regulatory framework for futures trading. NYMEX has experienced first hand the business opportunities provided by that extraordinary law and would urge that the major provisions of that law remain unchanged, including the rule self-certification process and the ability of the futures exchange to determine the best terms and conditions of a futures contract listed on its exchange. Derivatives markets contribute to the efficient allocation of resources in the economy because the price, which is derived through a highly liquid, transparent and competitive market, influences production, storage, and consumption decisions. These markets touch many aspects of the U.S. and global economy and, consequently, our lives. They can only effectively serve their economic purpose if they are allowed to trade and respond to market fundamentals without artificial restraints.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today.