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Testimony

Testimony of James A. Overdahl, Chief Economist
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Chairman Frank, Congressman Bachus, and Members of the Committee, I am pleased to have this opportunity to testify on behalf of the Commodity Futures Trading Commission (CFTC) on hedge funds and systemic risk. The Chairman of the CFTC is a member of the President's Working Group on Financial Markets (PWG). In this capacity, the CFTC participated in the deliberations that resulted in the agreement announced by the PWG in February setting out principles and guidelines regarding private pools of capital.

I will focus my remarks today on how hedge funds intersect with the CFTC's statutory responsibilities under its governing statute, the Commodity Exchange Act (the CEA). At the outset, I should emphasize that the CFTC does not regulate "hedge funds" per se. However, the CFTC encounters hedge funds as it performs two of its critical missions under the CEA: promoting market integrity and protecting the public from fraud in the sale of futures and commodity options. Hedge funds are on the CFTC's market surveillance radar when they trade in the regulated futures and commodity options markets, regardless of whether their operators and advisors are registered or not. With respect to investor protection, if a collective investment vehicle, such as a hedge fund, trades futures or commodity options, the fund is a "commodity pool" and its operator and advisor may be required to register with the CFTC and meet certain disclosure, reporting, and recordkeeping requirements.

My testimony today will address five topics. First, I will share some observations regarding the participation of hedge funds in regulated futures markets. Second, I will describe the CFTC's surveillance methods used to monitor large traders, including many hedge funds. Third, I will describe the CFTC's investor protection regime aimed at protecting customers from fraudulent practices in the sale of commodity pools, including hedge funds. Fourth, I will describe the financial safeguard system in place to ensure that the financial distress of a single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market. Finally, I will comment on our recent enforcement activities involving commodity pools and hedge funds.

Participation of Hedge Funds in Futures Markets

Futures markets serve an important role in our economy by providing a means of transferring risk from those who do not want it to those willing to accept it for a price. Traders who are trying to reduce their exposure to price risks, that is, "hedgers," typically include those who have an underlying commercial interest in the commodity upon which the futures contract is based. For example, futures contracts allow a bank to transfer its risk exposure to rising interest rates, a grain merchant to hedge an expected purchase of corn, or an oil refiner to lock in the price of its heating oil and gasoline output. In order for these hedgers to reduce the risk they face in their day-to-day commercial activities, they need to trade with someone willing and able to accept the risk. Data from the CFTC's Large Trader Reporting System indicate that hedge funds, and other professionally managed funds, facilitate the needs of commercial hedgers to mitigate their price risks, and add to overall trading volume, which contributes to the formation of liquid and well-functioning markets. Comparing findings from the CFTC's 1996 hedge fund study (using 1994 data) to today, we see that the average number of funds participating in futures markets has grown across nearly all markets. Also, it appears that funds, on average, hold positions in more markets today than in 1994.

CFTC large trader data also show that hedge funds and other professionally managed funds hold significant arbitrage positions between related markets. These arbitrage positions are structured to profit from temporary mispricing between related contracts (*e.g.*, prices for October delivery vs. prices for November delivery) and, when structured as such, are unrelated to the overall level of futures prices. These arbitrage trades play an important role in keeping prices of related markets (and prices of related contracts within the same market complex) in proper alignment with one another. On the one hand, to the extent that hedge funds and other arbitrageurs judge these price relationships correctly, the arbitrageurs profit. On the other hand, if they misjudge these price relationships they may lose. The losses may be significant as market discipline may punish errors in market judgment severely.

One notable market development in recent years has been increased participation by hedge funds and other financial institutions in futures markets for physical commodities. These institutions view commodities as a distinct "asset class" and have allocated a portion of the portfolios they manage into futures contracts tied to commodity indexes. The total investment in commodity-linked index products by pension funds, hedge funds and other institutional investors has been estimated by industry observers to exceed $100 billion in assets. A significant portion of this amount finds its way into the regulated futures markets, either through direct participation by those whose commodity investments are benchmarked to a commodity index, or through participation by commodity index swap dealers who use futures markets to hedge the net risk associated with their dealing activities. Notably, although the percentage of participation by hedge funds has increased in recent years, commercial traders in these markets remain, by far, the largest segment of trading category.

Surveillance Methods Used by the CFTC to Monitor Large Traders Including Hedge Funds

In the CFTC's world of regulated futures exchanges, market integrity is essential to preserving the important functions of risk management and price discovery that the futures markets perform in the U.S. economy. The CFTC relies on a program of market surveillance to ensure that markets under CFTC jurisdiction are operating in an open and competitive manner, free of manipulative influences or other price distortions. The backbone of the CFTC's market surveillance program is its Large Trader Reporting System. This system captures end-of-day position-level data for market participants meeting certain criteria. Positions captured in the Large Trader Reporting System typically make up 70 to 90 percent of all positions in a particular exchange-traded market. The Large Trader Reporting System is a powerful tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate the market. For surveillance purposes, the large trader reporting requirements for hedge funds are the same as for any other large trader.

Using large trader reports, CFTC economists monitor futures market trading activity, looking for large positions that might be used to manipulate prices. Each day, for all active futures and option contracts traded on the regulated exchanges, surveillance staff members monitor the daily activities of large traders and key price relationships. In addition, CFTC market analysts maintain close awareness of supply and demand factors and other developments in the underlying cash markets through review of trade publications and government reports, and through industry and exchange contacts. These analysts also closely track the net positions of managed money traders as a class to monitor for any market irregularities or trends. The CFTC's surveillance staff routinely reports to the Commission on surveillance activities at regular closed surveillance meetings as well as on an as-needed basis.

Market surveillance, however, is not conducted exclusively by the CFTC. Each futures exchange is required under the CEA to affirmatively and effectively monitor trading, prices, and positions. The CFTC examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfilling this important responsibility. The CFTC staff's findings from these rule enforcement reviews are reported to the CFTC, and are publicly posted on the CFTC Website (www.cftc.gov). Furthermore, exchanges impose speculative position limits and position accountability levels, where appropriate, to guard against manipulation. For example, NYMEX imposes spot month speculative limits on its energy contracts.

When the CFTC's surveillance staff identifies a potentially problematic situation, the CFTC engages in an escalating series of communications with the largest long- and short-side traders—which may be hedge funds—to address the concern. Typically, the CFTC's staff consults and coordinates its activities with exchange staff. This targeted regulatory oversight by CFTC staff and the exchanges is quite effective in resolving most potential problems. However, hedge funds normally close positions prior to the expiration month when manipulation is most likely to occur, and simultaneously establish similar positions in more distant months, because most do not have the capabilities or desire to make or take delivery of the underlying commodity. This process is referred to as rolling over a position.

Given the CFTC's statutory role as an oversight regulator, and the exchanges' statutory responsibility to monitor trading to prevent manipulation, the law requires that the exchanges take the lead in resolving problems in their markets, either informally or through emergency action. If an exchange fails to take actions that the CFTC deems necessary, the CFTC has broad emergency powers to direct the exchange to take such action that, in the CFTC's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. Fortunately, most issues are resolved without the need for the CFTC's emergency powers, as the CFTC has had to take emergency action only four times in its history.

CFTC's Oversight Authority with Respect to Operators and Advisors of Commodity Pools, Including Hedge Funds

Of no less importance is the CFTC's responsibility to protect investors who participate—whether directly or through participation in a professionally managed fund—in the futures markets through a diverse array of commodities products. To that end, the CFTC maintains a customer protection regime that, pursuant to the CEA, relies on full and timely disclosure to protect investors from abusive or overreaching sales practices. This encompasses persons who participate in commodity pools, including hedge funds.

Registration is the cornerstone of the CFTC's customer protection scheme. As of March 31, 2007, there were approximately 1,500 Commodity Pool Operators (CPOs) and 2,600 Commodity Trading Advisors (CTAs) registered with the CFTC, operating and advising approximately 2,300 commodity pools. In annual reports filed for 2005, the last full year for which data are currently available, CPOs reported total assets under management for commodity pools of approximately $700 billion, of which less than five percent represent direct investments in the futures markets.

The primary purposes of registration are to ensure a person's fitness to engage in business as a futures professional and to identify those persons whose activities are covered by the CEA. Generally speaking, those who operate or manage a commodity pool must register with the CFTC as CPOs, and those who make trading decisions on a pool's behalf must register as CTAs. Registration is not dependent on whether commodity interests are traded for speculative or hedging purposes, or on whether they are the predominant investment traded or advised. Notable exclusions or exemptions are available for operators of pools that are otherwise regulated; that have only sophisticated participants and de minimis commodity interest trading; and that have only a very high level of sophisticated participants, regardless of the amount of commodity interests traded. Hedge fund operators frequently fall within one of the latter two exemptions from CPO registration.

Once registered, a CPO or CTA must comply with certain disclosure, reporting, and recordkeeping requirements designed to ensure that prospective and current participants in commodity pools receive all the information that is material to their decision to make, or maintain, an investment in the pool. For example, prospective participants must receive information regarding the pool's investment program, risk factors, conflicts of interests, and performance data and fees. Thereafter, a CPO must provide pool participants with an account statement at least quarterly, and an annual report containing specified financial statements that must be certified by an independent public accountant and presented in accordance with Generally Accepted Accounting Principles (GAAP).

The CFTC has established a simplified regulatory framework for registered CPOs and CTAs who operate or advise pools whose participants meet specified financial and sophistication criteria. Relief consisting of reduced disclosure, reporting, and recordkeeping requirements is available where, for example, pool participants are CFTC or SEC registrants, "inside employees" of the CPO or CTA, or persons who earn $200,000 annually and who have investments with an aggregate market value of at least $2 million. Many of the pools for which CPOs are exempt from disclosure, reporting, and recordkeeping regulations are likely to be hedge funds.

Having outlined what CFTC regulation involves, it is important to note the limits of that regulation. The CFTC's mandate under the CEA does not include imposing limits on the pool's market risk or leverage parameters, or the instruments that may be traded, or imposing capital requirements or risk assessment procedures. As with the activities of a CPO or CTA, no matter the size of the pool they operate and/or advise, the CFTC's regulatory framework focuses upon disclosure of relevant, material information to pool participants, rather than prohibitions on conduct.

Finally, the day-to-day monitoring of CPOs and CTAs is carried out by the National Futures Association (NFA), the futures industry analogue of the National Association of Securities Dealers, and an organization of which futures industry registrants must be members. NFA's responsibilities include the registration processing function and review of CPO and CTA disclosure documents and pool financial statements. Consistent with the disclosure-based regulatory regime under the CEA, review of pool financial statements focuses on ensuring that they include all required information and conform to applicable accounting standards, but does not include an analysis of the pool's underlying transactions themselves. As part of its self-regulatory responsibilities, NFA conducts on-site examinations of CPOs and CTAs on a routine, periodic basis. NFA generally examines CPOs and CTAs within two years of their becoming active, and every four years thereafter.

Consistent with the recommendations contained in the President's Working Group Principles and Guidelines on Private Pools of Capital, the CFTC participates actively in the work of the International Organization of Securities Commissions (IOSCO) to expand the sharing of information among regulators, address systemic risk issues and strengthen the disclosure of data needed to assess risk. For example, the CFTC participates in work of IOSCO's Standing Committee on Investment Management, which this past year issued a draft consultation report recommending general principles for the valuation of hedge fund assets, and currently is studying regulatory and investor protection issues arising from the participation by retail investors in hedge funds.

Hedge Funds and the Futures Industry's Financial Safeguard System

The collapse of funds operated by Long Term Capital Management in 1998 and Amaranth Advisors, LLC., in 2006 highlight concerns about the risks potentially posed by a large hedge fund on the financial system as a whole. Within the futures industry, the clearinghouse affiliated with each exchange and the clearing member firms of each clearinghouse play a critical role in ensuring that the financial distress of any single futures market participant, whether or not that participant is a hedge fund, does not have a disproportionate effect on the overall market. This is primarily accomplished through a clearinghouse's financial safeguards.

All market participants must have their futures transactions, and the positions resulting from such transactions, cleared at a futures clearinghouse through a clearing member firm of that clearinghouse. Clearing member firms that carry positions on behalf of others must be CFTC-registered futures commission merchants (FCMs). FCMs are financial intermediaries that must adhere to CFTC-specified minimum net capital requirements.

Futures clearinghouses use a variety of financial safeguards to protect the clearing system from the financial difficulties of any firm that is part of that system. A clearinghouse's financial safeguard system involves multiple tiers. The first tier is the payment and collection of daily variation margin. At least once each day, clearinghouses mark open positions to the current market price and collect funds, in cash, from firms whose positions have lost value and pay to firms whose positions have gained value. The second tier includes the performance-bond margin deposited by clearing member firms with the clearinghouse to support open positions held on behalf of their customers or for their own proprietary accounts. The third tier may include the capital of the clearinghouse in excess of the working capital required for continuing clearinghouse operations. Clearinghouses also typically maintain guarantee funds made up of security deposits posted by each clearing firm. If all of these funds are exhausted, many clearinghouses have the right to assess clearing members for unsatisfied obligations. Clearinghouses also hold credit lines to ensure that funds are immediately available in the case of an emergency. Finally, clearinghouses perform daily surveillance of open positions, frequent stress testing, and periodic risk evaluations of clearing member firms in an attempt to detect potential weaknesses in financial condition or risk controls.

In addition to these safeguards at the clearing organization level, each clearing member firm has its own financial safeguards in place to protect itself from the financial distress of a customer—including a hedge fund customer. For example, each clearing firm is required under exchange rules to collect a specified minimum level of performance bond from each customer.

CFTC Enforcement Overview: Commodity Pools, Hedge Funds and CPOs

The CFTC takes its enforcement responsibilities with respect to CPOs, CTAs, and commodity pools very seriously. Whether registered or unregistered, exempt or not exempt, CPOs and CTAs remain subject to the CFTC's anti-fraud authority. Over the past seven fiscal years, the CFTC filed 58 enforcement actions involving commodity pools, hedge funds and CPOs. These enforcement actions typically involve investments in commodity pools, including self-styled hedge funds, in which the investors' funds were misappropriated or misused, or where investors were victimized by solicitation fraud involving misrepresentations of assets under management and/or profitability. The CFTC's Division of Enforcement currently has 34 pending litigations and approximately 20 additional open investigations and preliminary inquiries concerning commodity pools, hedge funds and CPOs.

The majority of the CFTC's pool fraud cases have been brought against unregistered CPOs. These cases tend to involve ponzi schemes or outright misappropriation, as opposed to legitimate operations. Sanctions in CFTC enforcement actions can include permanent injunctions, asset freezes, prohibitions on trading on CFTC-registered entities, disgorgement of ill-gotten gains, restitution to victims, revocation or suspension of registration, and civil monetary penalties.

The CFTC has taken enforcement action in several well-publicized recent hedge fund frauds. Because these hedge funds engaged in futures-related activities, the CFTC took action to punish illegal conduct (whether it occurred during solicitation of prospective participants or as an aspect of trading by the pool), deter future violations, and seek recovery of monies taken from innocent victimized investors. The following two cases, filed within the past three months are illustrative:

On April 25, 2007, the CFTC filed an enforcement action against Anthony A. Demasi and his company, a self-described hedge fund called Tsunami Capital, LLC. Since at least December 2004, the defendants allegedly solicited commodity pool investments based upon a false track record of trading profits when in fact there were either trading losses or no trading at all. Current investor losses have been estimated to be in excess of $12 million.

On April 17, 2007, the CFTC filed an injunctive action against Parish Economics, LLC and its president and owner, Albert E. Parish Jr., alleging commodity pool fraud. The commodity pool in question purportedly invested in “the commodity and stock futures and options markets.” However, commencing in or about January 2003, the pool allegedly issued false account statements and also misappropriated funds. The investors’ current estimated losses from this alleged fraud, which include a large share of the endowment fund of the university where Parish was a professor, exceeds $50 million.

In many instances, the CFTC works cooperatively with NFA, state regulators, criminal authorities and/or the SEC in bringing such actions. In Parish, for example, based upon the same conduct alleged by the CFTC, the SEC and United States Attorney for the District of South Carolina have also brought charges.

Conclusion

In closing, I want to repeat that the CFTC’s primary mission under the CEA includes ensuring market integrity and customer protection. Hedge funds that trade futures and commodity options on CFTC-regulated exchanges implicate both. Thus, the CFTC monitors participation by hedge funds in the regulated futures markets, as it does with other large traders, in order to ensure that these markets operate free of price distortions. The CFTC also administers a disclosure-based regime designed to ensure that prospective investors in commodity pools receive all the information that is material to their decision to invest in pools and, once invested, to remain pool participants; when problems are uncovered, the full force of the CFTC’s enforcement authority is devoted to prosecuting those responsible. The CFTC will remain vigilant in utilizing the tools provided in the CEA—market surveillance, disclosure, reporting and recordkeeping, and enforcement authority—to fulfill its statutory responsibilities as hedge fund participation in the futures markets continues to expand.

This concludes my remarks. I look forward to your questions.