

Senate Democratic Policy Committee Hearing
**“Lessons from Enron:
An Oversight Hearing on Gas Prices and Energy Trading”**

Michael Greenberger
University of Maryland School of Law

TRANSCRIBED STATEMENT AND COMMENTS

May 8, 2006

Thank you very much. I too, am going to submit my testimony which tries to give you a history of the way the Commodity Futures Trading Commission has dealt with the issue you're considering today.

I want to say in the first instance, as you know, the Commodity Futures Modernization Act (CFMA) was added under cover of darkness, in the middle of the night, to an 11,000-page consolidated appropriations bill during a lame-duck Congress in December, 2000. It was signed into law December 21st, 2001.

All the trading we're talking about today, the inability to see it, the fact that it's off-line, nobody knows what is going on, was illegal on December 20th, 2000. On December 21st, 2001, it became legal. And the Enron online operation which, by the way started before the law was passed - because they were so confident of its being passed - has been mimicked throughout. The electricity scandal was a school for scandal.

And the school is such today that you're not going to find the tapes that were uncovered in the electricity market. When we talk about other commodity markets, they've learned 'you don't tape that,' just like Osama bin Laden has learned not to use cellular telephones. They've learned not to leave an audit trail behind. They were so confident after the Commodity Futures Modernization Act was passed, and I am sure there weren't two Senators who understood what was in that 262-page law. It was written in seven different Wall Street law firms. There are exemptions on exemptions on exemptions, because they wanted to make sure that these trading facilities would not be seen by the public.

Every commodity market we look at today is approaching record prices - even the agricultural commodities. And this is going to set off not only a problem at the gas pump, but you're going to set off the possibility of inflation, which has now been talked about.

Now, the Futures Market is essentially a price discovery mechanism. When you go to buy a house in a community, you don't just let the real estate broker tell you how much you're going to pay. You want to know what other houses are charging or what the cost

is. The futures market serves the same process. So if you have people committing 'wash trades' in houses - that is, buying them for no economic reason and driving the price up - the real estate broker is going to come to you and say, 'the price is +X over the economic fundamentals of what that house is going to cost.' That is exactly what is happening today in the commodity markets; it is exactly what is happening in the oil markets.

As the Chairman of British Petroleum just so articulately said, as pointed out by Senator Feinstein, economic fundamentals do not explain this market. What is happening is phony trading is going on in the futures market and then the oil companies and the gasoline retailers say 'oh, well that's the price - that's the way we know what the price is.' And it's been pumped-up.

With regard to natural gas, the conservative members of the House supported the same kind of legislation that you and Senator Feinstein have introduced and made it part of their Commodity Futures Reauthorization Act, for natural gas because their constituencies are not looking at this from free-market/non-free-market systems. They were in December, 2005 paying through the teeth for natural gas. Interestingly enough, December 14th, 2005, when the House passed that legislation, was the peak for the natural gas market. It started to sink. Why? Because the traders now understand that what they're doing in those markets may be discovered and they have to be very careful. My bet is that if the Senate passed [Feinstein's] legislation, that that passage in and of itself would substantially drive down the oil futures market.

One other thing; Enron online started this, the energy exemption was gotten at their behest. But it's because the electricity manipulation was a school for scandal, everybody wants a piece of this. There are now 420 some hedge funds who are thought to be principal traders in this market. Now, hedge funds are creating a double-opaqueness. One, as you know, hedge funds are basically unregulated or lightly regulated, and their trading in products that are unregulated. So as all these state enforcement officials have told you, you do not know what is going on in these markets.

The final point I want to make, is we keep saying the CFTC is not able to find this out. Unfortunately, as the CFTC sits there today, they don't want to find this out. The most critical arguments made against looking at this market are by Commissioners from the Commodity Futures Trading Commission. And the reason for that is it is a very small agency. I served there for two years under Chairperson Born, who tried to bring transparency to these markets. And I am sure Senator Cantwell as you saw when you introduced your legislation in 2002 that the lobbying and the amount of money that goes into arguing against this, and moreover, not only arguing against it but embarrassing the people who are trying to argue against it, is a 24 hour a day, 7 day a week operation. The Commodity Futures Trading Commission, sadly but truly does not have the courage to look into this market. So it's one thing to pass this legislation. It's another thing to make sure they use this legislation.

And finally, I would just say that the ICE exchange *does* have an obligation to keep records. It came into existence in a no-action letter given to the International Petroleum

Exchange, which was a foreign entity trading foreign products in 1999. In 2001 it was bought by ICE. Now that trading has mostly shifted to Atlanta, but they are still operating under the no-action letter. And who is their principal regulator? Not the CFTC, the UK Financial Services Authority, even though it's an Atlanta based institution. The CFTC tomorrow could turn that around, and even under the no-action letter. I signed the first one for another London exchange. We were careful to reserve the right to get data. The CFTC tomorrow could order ICE to give it all the data it wants. Why doesn't it? Because ICE is really the play thing of big United States investment banks and there is not the courage to take on those banks and do what needs to be done.

I believe, were not only talking about exchanges other than NYMEX, we're talking about a massive over-the-counter market that nobody knows the extent of and who is in it. ICE is just a player in it besides NYMEX.

And finally, I would say the CFMA didn't just date deregulate the over-the-counter market, it deregulated ever market. NYMEX has less regulatory obligations today than it had December 19th, 2001. And Congressman Graves, a Republican from Missouri, who fought to get the transparency in the natural gas markets in the legislation that passed the house, cited as one of his examples: the rules and NYMEX have become so out of control that they encourage volatility on that exchange. So this is an area that needs to be looked at from top to bottom. And my own view is, I think it's a long way to saying you're against a free-market to saying that the free-market has to keep records and make it available in a time of crisis such as we're facing today.

Thank you.

GREENBERGER EXCERPTS FROM Q&A PERIOD

SEN. CANTWELL: Mr. Greenberger, you mentioned a couple of things there. First of all that the larger, over-the-counter transactions and the historical nature and broad exemption given to over-the-counter. Maybe you can spend few minutes talking about those contracts and the effect of those contracts versus the NYMEX, as far as oversight and transparency. And then if you can also comment on your... you mentioned that the NYMEX is missing some rules that it also have in place if I am not misunderstanding your point. If you could comment on that.

GREENBERGER: You understood me correctly. The Commodity Futures Modernization Act, against the recommendation of Alan Greenspan, Arthur Levitt, Secretary Summers and then CFTC Chairman Rainer, deregulated and allowed for energy commodity trading to be done outside of exchanges by computers and to be totally – except for having to tell the CFTC that they're doing it – they can just do this trading by themselves.

That was originally sponsored by Enron. Enron very badly wanted to legitimize what they were already doing, probably illegally, and have their Enron online validated. When the big investment banks were not particularly interested in this saw what could be done

in the California electricity crisis situation, they wanted to get into this trading in the over-the-counter commodity market big-time. And as I said, an example of that is there's supposedly over 420 hedge funds involved in this market, who aren't regulated by mutual funds and are dealing with these transactions, which happen over computer and nobody knows what's happening. It just goes on.

So when you heard the tapes about the wash trades earlier, and as Mr. McCullough said, they just stumbled upon that - no federal agency got that information - and some of it was voluntarily made available by lawyers for Enron in Portland, Oregon. Nobody is investigating that. Nobody is looking to see what happens. So that, for all we know, could be happening on a regular basis.

We do know that it is very profitable. Enron made a ton of money on it before the end came. But no one knows.

Let me say this: the exemption is in Section 2(h)(3) of the Commodities Futures Modernization Act. It creates an exempt commodity and exempt exchanges. It does allow the CFTC to do something about fraud and manipulation. And also I think a fair reading of that statute says that the CFTC can aggressively - when it has suspicions about something is happening - go in and collect the very kind of information that we want to seek today. But the CFTC...

SEN. CANTWELL: But not on over-the-counter?

GREENBERGER: Even over-the-counter, Senator Cantwell, and I would be happy to walk you through that. They do have fraud and manipulation, there are record keeping requirements in [Section] 2(h)(3), but the CFTC has treated it as if it isn't there. And they've taken the position *de facto*, they've never announced it. But when the Enron tapes and memos came out about everything that was happening, before that happened, they took the position they didn't have investigative authority here. They had to be *shown* fraud and manipulation. And finally, much to everybody's surprise, including the CFTC, it was shown, by people like Mr. McCullough, and otherwise. So they had to do something. And they investigated.

By the way, you talked about the billions and billions of dollars that were lost. After the investigation, the CFTC, throughout this industry, many institutions have collected \$300 million, basically its cost of doing business, damages. So I think there's an argument to be made: already they could look into this market. But clearly they don't want to, and that is why your legislation is so important.

Now then, when you get rid of the over-the-counter market your looking at the formal exchanges, that aren't these back-room, suspender-wearing investment bankers aiming for their big bonus at the end of the year. When you're talking about the exchanges, ICE is in business only because a predecessor company got a no-action letter on the basis of it being a foreign entity and that it would be regulated by the Financial Services Authority in the UK, that happened in 1991. In 2001, ICE bought [the International Petroleum

Exchange] and they've moved most of the trading to Atlanta. They now call themselves an Atlanta based company, and they are still treated as a foreign company being regulated by the FSA.

Now if that isn't bad enough, the no-action letters that granted the old IPE this authority, clearly – and I have it in my testimony – says – and I wrote the first one – I knew exactly what we were worried about. We were worried about manipulation on those foreign markets. 'We reserve the right to collect data,' its right there in the no-action letter. We reserve the right, and the Justice Department reserves the right. And, we not only reserve the right, but we made it a condition of every grant of no-action approval that there be an agreement between the foreign regulator and the CFTC that we could go to the foreign regulator to get that data. So there were two different ways to do it. But today, its as if that never happened. They continue to treat an Atlanta-based company, owned to a substantial ownership by US investment banks, as if its in London and not in Atlanta. Its just amazing.

Now, then you come to NYMEX, the so-called 'good exchange' that is carefully regulated. In the CFMA, they completely changed the way these exchanges were regulated. Essentially they told the exchanges, put simply – and I emphasize simply – 'you do what you want to do... If we think its bad, we'll intervene, but we have to show by substantial evidence what you're doing wrong is bad.' They completely reversed the regulatory system of having to get approval before you do things.

And in that vein, these exchanges have loosened their own rules and regulations. One of the rules that has created concern is, just like in the New York Stock Exchange, when something goes wrong and a stock goes way up, or a stock goes way down, what happens? Dramatically, they stopped trading in the stock. It's a cooling off period. The Chicago exchanges still have what are called 'limit requirements.' If the commodity shoots up or the commodity shoots down, you intervene, stop trading for a significant amount of time, cooling off. What Mr. Huntsman is complaining about, the limits are so high and so low that they're almost as if they're not there, and when they're put into affect, they're put into affect for *five minutes*.

So the so-called 'good exchanges' that's regulated and we're all pointing to as examples has had its regulation so relaxed that it, too... Congressman Graves, Republican of Missouri, who lead the fight in the House, said the natural gas markets are being manipulated on the NYMEX exchanged. This needs to be looked at from top to bottom, not just for natural gas, because the oil things are going through the roof.

And by the way, ICE, on top of becoming a United States entity, treating itself as if its in London with the approval of the CFTC, introduced Untied States commodity contracts in January. And suddenly NYMEX got upset because they're now a direct competitor. They've taken 25 percent of NYMEX's west Texas crude market, the critical contract. So these markets are going crazy.

SEN. CANTWELL: Now Mr. Greenberger, and I do want Mr. Olsen to comment on some of this, too, but that's what is puzzling. Why don't you have the Chicago Mercantile Exchange, NYMEX and others raising concerns? I mean, here they are in a market operating with a great deal of transparency...

GREENBERGER: NYMEX is complaining now about ICE. And amazingly enough, the CFTC isn't doing anything about it, and having been CFTC alumni I can tell you exactly what's happening. Even though Chairman Newsome of the CFTC is now the President of NYMEX, and I am not saying he violates any rules but obviously he's a very bright, well-respected man, he wants parity with ICE. He's saying, they should be treated like a United States exchange.

Nothing has happened. Why? Because in the power politics of commodities business, the investment banks, the Goldman Sachs, the Morgan Stanleys, the City Banks, the JPMorgan Chase, run ICE. And the way business gets done at the CFTC is 'Who has the power?' Usually it's the traders versus the consumers. And the consumers have no power at the CFTC. Here it's a little exchange, or a fairly little exchange, versus the powers that be in the American financial community. And in that calculus, ICE is going to get away with murder. Simply put, that's what's happening.

Tomorrow, the CFTC could cancel the no-action letter, and tell ICE to register as a contract market and be on-par with NYMEX. Tomorrow, the CFTC could go to ICE and say, 'we want the following information...' As could the Department of Justice. Tomorrow, the CFTC could tell ICE, 'you can't trade when you're pretending you're a UK company, you can't trade United States products in competition with NYMEX.'

So, Chairman Newsome, now President Newsome, is trying to do something. Unfortunately, in this case, he does not wield the power that the investment banks do.

SEN. CANTWELL: Thank you, Mr. Greenberger.