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GAO previously recommended the establishment of an independent agency to regulate the commodity futures industry and still believes that such an agency is the most effective means of regulating the industry. A review of the Commodity Futures Trading Commission resulted in tentative findings that: more emphasis on planning is needed to improve the effectiveness and efficiency of operations; there are weaknesses in organization and management, such as limited management experience, division of responsibility, high rate of turnover, and use of outside experts who may not best represent the public interest; improvements are needed in the process for designating exchanges as contract markets; review of exchange rule enforcement is deficient; efforts at curbing abusive trading practices should be intensified; registration and audit programs could be more effective; market surveillance should be improved; and the Commission has been unable to provide effective regulation of the sale of commodity options. The newness of the Commission accounts for many problems. (NTW)

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Statement of
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Comptroller General of the United States
before the
Subcommittee on Agricultural Research
and General Legislation
Committee on Agriculture, Nutrition, and Forestry
United States Senate
on
The Commodity Futures Trading Commission

Mr. Chairman and Members of the Subcommittee:

We are here today to discuss the results of our review of the Commodity Futures Trading Commission. Although we have not finalized our report, we are more than happy to summarize for you our tentative findings and conclusions. We hope that our observations will be helpful to the Subcommittee in its oversight role and in its consideration of whether to reauthorize the Commission after fiscal year 1978.

REAUTHORIZATION

In a report to the Congress in May 1974 and in testimony before the Senate Agriculture Committee in the same month, we recommended that the Congress establish a separate, independent agency to regulate the commodity futures industry. Because the futures markets play a vital role in the country's economic well-being, we stated that they should be regulated by a strong and prestigious agency, as free as possible from outside influence.

We continue to believe that an independent agency is the most effective means of regulating the futures industry. While our review has identified many areas where the Commission can improve its performance, we believe that the Commission's implementation of the specific recommendations we plan to have in our forthcoming report will lead to improved regulation of the commodity markets. We recognize that implementation of all our suggestions for improvement will require additional budgetary and staff resources for the Commission.

We also recognize the newness of the Commission and the fact that most new organizations will have "growing pains" and will need a chance to iron out organizational and management problems. Therefore, we are in favor of reauthorizing legislation for the Commission.

In this regard, there have been a number of bills introduced concerning the reauthorization of the Commission.

Among them is S.2391, which would extend the life of the Commission for 5 years--through fiscal year 1983.

Futures trading is the buying and selling of contracts for delivery in some future month of specified quantities of a commodity at fixed prices. The function of the Commission is to strengthen the regulation of futures trading and to bring under regulation all agricultural and other commodities traded on futures markets.

During fiscal year 1977 the Commission had a budget of \$13.1 million to regulate 10 exchanges. The trading volume for calendar year 1977 was 42.9 million contracts valued at over a trillion dollars. In contrast, the former Commodity Exchange Authority in fiscal year 1974, its last full year of operation, had a budget of \$3.5 million. In fiscal year 1974 the Authority regulated trading in 18.5 million contracts valued at \$343 billion.

I would now like to highlight some of our tentative findings and conclusions.

ADDITIONAL EMPHASIS ON PLANNING
NEEDED TO IMPROVE EFFECTIVENESS
AND EFFICIENCY OF
THE COMMISSION'S OPERATIONS

Our review revealed that the Commission has been slow to recognize the need for planning and slow to implement a formalized planning process as a basic management function and decision tool. In the absence of a strong planning function, the agency's efforts have lacked focus and direction.

The Commission's regulatory posture has been overly ad hoc and reactive as opposed to anticipatory and preventative.

The Commission has found itself devoting considerable time and resources to such activities as the regulation of commodity options and investigation and punishment of alleged manipulative activity. At the same time, the Commission has not devoted enough attention and resources to research; education; information programs; development of staff expertise; and to improvement of programs with a preventative focus, such as market surveillance, monitoring of trade practices, and reviews of exchange trading records, rules, and contracts. These are areas which have high payoff potentials in terms of enhancing understanding, use, and regulation of futures markets.

A number of explanations were offered by various Commissioners and staff members for the lack of emphasis given to planning. One was that there was little interest in, or support for, planning on the part of the Commission. Another was that congressionally imposed mandates and deadlines contributed towards formation of an ad hoc, crisis management orientation which became ingrained. Another was that a lack of staff expertise in certain areas as well as the lack of basic information required for decisionmaking led to some recognizedly important tasks being postponed in favor of more easily accomplished work. Recent developments in planning and budgeting

at the Commission, including agency identification of priorities for fiscal year 1978, point toward possible improvements over time in the overall process of planning and resource allocation by the agency.

WEAKNESSES IN ORGANIZATION
AND MANAGEMENT HAVE HAMPERED
COMMISSION OPERATIONS

The Commission has been adversely affected by a number of specific organizational and management problems which have impaired its ability to make the most effective and efficient use of its resources. These problems include a shortage of management experience in the top executive positions, a lack of agreement concerning the division of responsibilities and authority between the Chairman and the full Commission, and a high rate of staff turnover coupled with an inability to develop professional cadres.

Limited management experience:
Chairman and Executive Director

The act provides for a strong Chairman type of Commission in which executive and administrative functions, including appointment and supervision of personnel, and distribution of business among personnel are vested in the Chairman.

The act also provides for an Executive Director, appointed by the Commission with the advice and consent of the Senate, to whom the Chairman may delegate any of his functions as he deems appropriate. The Chairman, acknowledging no prior management experience, has delegated to the Executive Director the

the authority for the day-to-day operations of the Commission. Because of his position and responsibility, the Executive Director should possess considerable management experience and skill. The Commission, however, has not obtained highly experienced managers for this position. The potential contribution of the Executive Director position has been further limited, in our view, by the turnover of incumbents and by the jurisdictional disputes which for many months characterized the relations of this office and other organizational units of the Commission.

Division of responsibility
between the Chairman and
the full Commission

A second factor which has adversely affected Commission operations is the lack of agreement concerning the statutory division of responsibilities between the Chairman and the full Commission, i.e., the differentiation between the executive and administrative functions of the Chairman and the policy formulation function of the full Commission. A number of Commissioners and staff expressed the view that the sections of the act which deal with this division of functions are vague and ambiguous and have unnecessarily complicated the functioning of the Commission. They cite as particularly troublesome the statutory language dealing with "general policies"--formulation of which the act reserves to the Commission as a whole--and that dealing with the use and distribution of funds which seems, confusingly, to be a function of both the Chairman and the Commission.

An example of disagreement stemming from this issue is the recent announcement by the Chairman of the creation of an Options Task Force, which would have involved the mobilization of substantial staff resources throughout the agency, to counter the problems of enforcement and customer protection growing out of the sale of commodity options. The Chairman's announced intention to create such a task force, which would necessarily have entailed diversion of resources from other Commission programs and activities, was met with strong opposition from the other Commissioners who viewed this unilateral declaration as an infringement of their authority to set general policy.

In connection with its deliberations on reauthorization, the Congress should reappraise the strong Chairman form of organization provided for by the act and determine whether modifications or clarifications are needed in the division of functions between the Chairman and the Commission as a whole.

High rate of turnover and loss
of most experienced personnel

A third factor which has adversely affected the organizational effectiveness and efficiency of the Commission is the relatively high rate of staff turnover which it has experienced, particularly the loss of some of its most experienced senior and mid-level professional staff members. For example, Civil

Service Commission statistics show that during fiscal year 1977, 163 employees left the Commission, equivalent to a "separation rate" of 35.8 percent, compared to an overall Government rate of 23.5 percent. In calendar years 1975 through 1977, a total of 156 professional employees, defined as GS grades 7 and above, left the Commission's employment. Many individuals who have left the Commission had been with it from its earliest days. Because of the delays in filling some of the vacancies, as well as the substantial learning curve involved in much of the Commission's work, the loss of these people has created gaps and slowed progress in a number of areas.

Use of outside experts

Additionally, the Commission has used outside experts who served on advisory committees to provide information and guidance for purposes of management decisionmaking and policy formulation. The composition of some of the advisory committees, however, raises questions of possible underrepresentation of the interest of the general public and possible industry overrepresentation in the formulation of Commission policy.

We noted, for example, that of the seven-member advisory group which considered the question of commodity options regulation and which developed a recommended regulatory scheme for commodity options, six individuals were clearly identifiable as being part of or having close ties to that segment of the

industry in the forefront of advocacy of commodity options trading. Five of the seven had ties to exchanges or firms that propose to trade commodity options upon implementation of the Commission's proposed options pilot program.

MARKET DESIGNATION PROCESS
NEEDS IMPROVEMENT

An important and far-reaching responsibility of the Commission is the designation of exchanges as contract markets in particular commodities. Our review showed that the Commission's contract market designation reviews, especially those performed at the time of initial designation in 1975, were not comprehensive enough to assure the designation of only those contract markets meeting statutory and Commission requirements. The initial designation reviews were performed hurriedly because the act required that they be completed within 90 days. The Commission has generally not performed more indepth followup reviews to assess whether the contracts and the exchanges currently meet requirements.

We also found that the Commission needs to better assure itself that proposed futures contracts are not contrary to the interest of the general public and that they serve some economic purpose, e.g. , hedging or price discovery.

RULE ENFORCEMENT REVIEW
PROGRAM NEEDS IMPROVEMENT

Exchange enforcement of their own rules is the key to the self-regulatory process which the Congress envisioned when it

established the Commission. As a necessary adjunct to its regulatory oversight, the Commission has implemented an exchange rule enforcement review program. However, reports by the Commission's staff evaluating rule enforcement at the New York and Chicago exchanges, including a January 1978 report on the Chicago Board of Trade, show that effective self-regulation in the commodity markets is not yet a reality. The staff reviews have disclosed numerous deficiencies in the rule enforcement programs of most of the New York and Chicago exchanges.

For example, the Commission's Trading and Markets Division concluded that the Board of Trade was not in compliance with a regulation requiring exchanges to monitor trading practices of its members. The Division's January 23, 1978, report to the Commission had this to say about the Board of Trade's apparent reluctance to improve its procedures for monitoring trading:

"This cavalier approach to rule enforcement makes a mockery of self-regulation. Complacency no longer can be abided in an industry 'affected with a national public interest.' Compliance with * * * the Commodity Exchange Act and [the Commission's] * * * regulations will remain an illusion as long as this attitude persists."

The report was also highly critical of the Board of Trade's efforts to comply with a Commission regulation requiring exchanges to promptly and effectively discipline members found to have violated exchange rules. The report pointed out that Board of Trade statistics show disciplinary action is taken in only about 4 percent of disciplinary cases. Further, most

of these sanctions involve either warning letters or cease and desist orders as opposed to fines or trading suspensions.

Our review of the Commission's rule enforcement program was primarily aimed at evaluating the effectiveness of its reviews and its overall policies and procedures for assessing, monitoring, and improving exchange compliance with statutory and Commission requirements on rule enforcement. We found that while the Commission's program has produced some positive results, program effectiveness can be increased by establishing (1) uniform guidelines for performing reviews and documenting the work performed; (2) better criteria for evaluating exchanges' performance; and (3) more effective and prompt follow-up procedures to assure that exchanges correct deficiencies. Additionally, the Commission should determine whether deficiencies uncovered by its reviews constitute violations of the act or Commission regulations and it should establish policy for taking enforcement action against violators, such as cease and desist orders, fines, suspensions, or revocation of trading privileges.

Furthermore, the Commission needs to better monitor exchange disciplinary committee proceedings to assure that the committees operate in a conflict-of-interest-free environment. For example, we found instances in which disciplinary committee members at an exchange had a financial interest in the firms appearing before the committee. The Commission has recently issued proposed regulations dealing with this issue.

REGULATORY ISSUES CONCERNING
ABUSIVE TRADING PRACTICES--
MUCH REMAINS TO BE DONE

Assuring that the trading public is protected from abusive trading practices on the floor of the exchanges is one of the primary reasons for Federal regulation of the commodity futures industry. However, the Commission's efforts on many important regulatory issues related to curbing such practices need to be intensified.

Floor brokers and futures commission merchants and their representatives often trade for themselves as well as for customers. This practice, known as dual trading, can at times result in a floor broker or futures representative directly competing with a customer's interest. Resolution of the question of whether to continue to permit dual trading by brokers and commission merchants, as required by the 1974 Act, was one of the pressing issues facing the new Commission. However, the Commission's approaches to dual trading and the related areas of trading record accuracy and time stamping were neither comprehensive nor systematic. The Commission needs to develop and analyze empirical evidence to determine whether dual trading is necessary for trading liquidity or whether it promotes trading abuses--key considerations in resolving dual trading questions. Also, the Commission generally has been lax in enforcing and/or implementing regulations on trading standards and time stamping of transactions aimed at minimizing abusive practices which may result from dual trading.

A most effective way to deter and detect trading abuses is the reconstruction of historical trading patterns and data by means of trade practice investigations. Although the Commission should have performed such investigations on a routine basis, it has only performed six to date. Until the Commission expands and improves its trade practice investigations program, unscrupulous brokers or futures commission merchants have little to fear concerning the Commission's ability to detect abusive trading practices.

REGISTRATION AND AUDIT PROGRAMS
CAN BE MORE EFFECTIVE

The Commission's registration program is not as effective as it could be in preventing registration of unfit and unqualified individuals. To better protect the trading public the Commission should explore the feasibility of fingerprinting registration applicants, a practice recently instituted in the securities industry. Also, the Commission should significantly upgrade its screening of applicants for reregistration. Until improvements are made, the Commission may be routinely registering and reregistering applicants with criminal convictions or violations of the act or regulations.

Also, the Commission needs to perform test checks to insure that individuals and firms required to be registered by the Commission are, in fact, registered. For example, such checks can be performed as part of the Commission's rule enforcement reviews and its audits of registrants. Finally,

the Commission should establish and enforce qualification and proficiency standards for registrants.

The Commission does not audit commission merchants often enough to assure that customers' funds are adequately safeguarded. Also, the Commission needs to take stronger action against commission merchants who violate financial and record-keeping regulations.

For example, in looking at Commission audit files of eight futures commission merchants in New York, we found that each had a history of violating segregation and record-keeping provisions of the act or regulations. The Commission repeatedly sent warning letters to the firms but initiated enforcement proceedings in only one case. To illustrate, one of the firms did not comply with a Commission regulation requiring that all money belonging to customers as a result of futures trading be separately accounted for, i.e., segregated. A 1976 Commission audit report disclosed that the firm was undersegregated by from \$400,000 to \$4.7 million during an 8-month period in 1975 and 1976. Prior audits showed that the firm commingled customers' funds on four occasions between 1972 and 1974. After the current audit the Commission sent the firm a warning letter but did not start enforcement proceedings.

The Commission has proposed regulations which are aimed at implementing our 1975 recommendation that it redirect its audit effort to a strong oversight role and transfer to the

exchanges the primary responsibility for enforcing financial provisions of the regulations, such as minimum financial requirements.

NEED TO IMPROVE MARKET SURVEILLANCE

The primary purpose of surveillance of market activity is to detect and prevent market disruption, such as the manipulation of the price of a futures contract. Market surveillance is a multifaceted process involving, among other things, collecting and analyzing various market data.

In comparing market surveillance performed by the Commission and that performed by exchanges, we found that there is a need to eliminate unnecessary duplication and to increase coordination among the participants.

We also concluded that the Commission should

- follow up on and resolve market surveillance problems, such as improving the timeliness of surveillance data, which were identified in reports prepared by the agency's Chief Economist in 1975 and 1976;
- develop an early warning system using quantitative market indicators for detecting potential market problems; and
- improve the reliability of the cash market transactions used for market surveillance.

REGULATION OF COMMODITY OPTIONS

A commodity option, in contrast to a commodity futures contract, represents a right, but not an obligation, to buy

or sell a commodity at an agreed upon price within a specified time. The trading of commodity options on domestic exchanges was banned by the Commodity Exchange Act of 1936, and this ban has been carried over into the 1974 Act in the case of the "previously regulated commodities," i.e., those commodities regulated prior to 1974. In the case of commodities not previously regulated, the 1974 Act authorizes the Commission to determine whether and, if so, in what fashion options trading should be permitted on domestic exchanges. Foreign commodity and dealer options have been available in this country throughout the period since 1936 and have recently been the subject of widespread investor interest.

The Commission has been unable to provide effective regulation of the sale of commodity options. At the same time, the Commission's attempts to develop and enforce its options regulations and to prevent fraudulent and illegal activity in the sale of options have constituted a heavy drain on the resources of the agency and have seriously interfered with its ability to deal with its more basic responsibility for regulation of commodity futures.

Wide agreement now exists among Commissioners and staff that early action by the Commission to temporarily ban the retail sale of foreign options would have had very few adverse consequences since relatively few firms were thought then to be in the business of selling options. The promulgation of options regulations by the Commission, including

registration, segregation, and minimum capital requirements which the Commission had difficulty enforcing, has attracted customer attention as well as the participation of allegedly fraudulent operators who have seen the potential for quick profits through high-pressure, boiler-room-type operations.

Because the 1974 Act granted the Commission exclusive jurisdiction over options--preempting the States and the Securities and Exchange Commission regulatory activities--the Commission should have carefully assessed whether it had the necessary resources to regulate options. Such an assessment, at a minimum, should have resulted in a cautious go slow attitude towards options. This, however, was not the case. The Commission, which acted to assert its exclusive jurisdiction over options even before it issued its interim options regulations in late 1976, was in no position to match the customer protection and enforcement capability of the Securities and Exchange Commission and State securities agencies. What is more, the Commission had been warned of this in July 1976 by a public member of its Advisory Committee which had considered the question of regulating commodity options.

Another factor which, in our opinion, called for delay in the implementation of options regulations, was the relative lack of experience of the new agency as well as the very considerable amount of unfinished work which remained to be done in meeting the requirements of the act and in

fulfilling the Commission's considerably expanded mandate for regulation of futures markets.

Having decided to regulate foreign options and having implemented interim options rules in late 1976 and early 1977, the Commission did not have to adhere to this course. Once the Commission found itself unable to enforce its regulations, it could have reversed its position and placed a moratorium on the sale of foreign options.

In addition, because it was seriously understaffed and unprepared to compel strict compliance with any of its options rules, the Commission was never able to make of its registration, segregation, recordkeeping, disclosure, and antifraud rules the meaningful customer protections they might otherwise have been. A number of options firms, among them some of the largest, operated in open defiance of Commission rules, including rules requiring registration of principals and representatives of futures commission merchants, rules requiring keeping of books and records for Commission inspection, and rules relating to maintenance of minimum levels of capital. The Commission only recently, in the face of revelations of alleged fraud and customer abuse as well as intense criticism from State officials who claim that their citizens are not being adequately protected by the Commission, has concluded that it may have to ban the sale of foreign options after all.

The Commission still intends, however, to go ahead with plans for implementation of a pilot program to permit trading

of options on domestic exchanges. In fact, it has requested a supplemental appropriation for this purpose for fiscal year 1978 as well as a budget increase for fiscal year 1979. Although such an options pilot test may in time be appropriate, we believe that implementation of such a program is inadvisable at this time. Instead of options, the Commission should devote all its resources, including any supplemental appropriations, to improving the regulation of futures trading. As our statement points out, we have identified many areas, basic to the effectiveness of futures regulation, which are greatly in need of improvement.

Because of time constraints, we have not described in this statement all topics that will be covered in our forthcoming report. Some of the additional topics that will be dealt with in our report include

- Commission leasing of real property, including the need for congressional clarification of leasing authority;
- problems with respect to the Commission's reparations program, a program for the redress of customer grievances against Commission registrants;
- Commission safeguards against the misuse of confidential agency information; and
- Commission requirements for filing of financial disclosure statements.

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We discussed our principal findings and conclusions with the Chairman and the Acting Executive Director. They generally agreed with our conclusions but indicated that the Commission did not have sufficient staff and resources to implement some of our suggestions.

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This concludes my prepared statement. We shall be glad to respond to any questions you may have.