**Commodity Futures Trading Commission**
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# Speech

## Walk Softly and Carry a Big Stick

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I'd like to thank Bob Pickel and ISDA for inviting me to speak today addressing the important topics of energy and developing products. ISDA has been an innovative leader on these issues and I appreciate their work over the years to keep the derivatives market an engine of growth for the economy.

There have been several important changes at the CFTC of late. We have two new commissioners – ISDA's very own Jill Sommers and Bart Chilton. I know I speak for Commissioner Dunn in saying they have been welcome additions to the Commission for their unique experiences and insights.

To say the least, it has been a busy time since taking over as Acting Chairman in July. In those five short months, I testified three times before Congress, the Commission held two public hearings and provided an extensive report to Congress on the regulation of exempt commercial markets, Congress is actively debating the CFTC's reauthorization, the markets have experienced a major credit crunch resulting from the sub-prime crisis, including the implosion of a large FCM, the CFTC and FERC filed their respective cases against Amaranth, and the CFTC and Department of Justice reached a record settlement with BP for manipulating the propane market. Although my wife wishes otherwise, I do not see the pace of things slowing down any time in the near future.

Much of the job of regulating is reacting to such situations as they arise. This is inevitable given the nature of the financial markets and its broad array of participants. But regulators should not be content to just play defense—we must be ready to anticipate trends as our industry and markets evolve.

Without a doubt, the largest structural change affecting the oversight of our markets in the last decade is global competition brought on by the cyber-revolution. Without leaving their desks, traders now have a variety of choices on where to trade financial products, regardless of physical borders. This competition has significantly lowered costs and spurred innovation. In addition, the abundance of affordable technology and bandwidth has made trading location almost irrelevant from a latency point of view. Traders can now plug in and trade from virtually anywhere in the world.

Technology allows a world marketplace to exist but for the rigid laws and regulations that hamstring its development. Unfortunately, regulation often lags behind these global market trends and regulators frequently find themselves playing catch-up as problems unfold. Regulators may attempt to meet these challenges by adopting detailed rules, but the breakneck pace of innovation inevitably changes the landscape, making the rules outdated almost upon enactment.

Given the speed of our markets, we are left asking: how do regulators keep pace? To be honest, keeping pace is optimistic—realistically, regulators as a whole are fortunate to keep the industry's taillights in view. Globalization, and its impact on product innovation, is rampant and while the private sector views globalization as an opportunity, regulators are grudgingly adapting to the modern economy. In a recent survey by IBM, 95 percent of the financial industry interviewed thought globalization to be a growth opportunity rather than a threat. Of the five percent who felt threatened, nearly all were regulators. Why is this? Because regulators understand that globalization shakes the foundation of their regulatory models.

Regulators no longer live in a “bright-line” jurisdictional world. Determining where an exchange or firm is located is difficult, if not impossible, with subsidiaries, boards of directors, customers, clearinghouses and self-regulators scattered around the globe. To say the least, it is difficult—but I think the key for regulators is not only to work harder, but work smarter.

It was the adoption of “principles-based” regulation with the passage of the Commodity Futures Modernization Act (CFMA) in 2000 that has allowed the CFTC to work smarter. There has been much debate recently on the relative benefits of outcome-based principles versus rules. There is a developing consensus in the U.S. that principles-based regulation is a model worthy of study, noting that the UK markets are flourishing under such an approach. But rather than fly to London, Washington policymakers need only visit New York or Chicago where the U.S. futures industry has been thriving under principles since the passage of the Commodity Futures Modernization Act (CFMA) in 2000.

A principles-based system requires markets to meet certain public outcomes in conducting their business operations. For example, U.S. futures exchanges must continuously meet 18 core principles—ranging from maintaining adequate financial safeguards to conducting market surveillance—in order to uphold their good standing as a regulated contract market. Such an approach has the advantage of being flexible for both regulator and regulated. As technology and market conditions change, exchanges may discover more effective ways to meet a mandated principle.

But today I want to focus today on what is sure to be an important issue in the minds of policymakers debating the benefits of a principles-based regulatory approach—enforcement. Can enforcement be meaningful in a principles-based regime? Can enforcement programs fulfill their missions without the certainty of rules-based compliance? The answer to these questions is a resounding yes and we need to look no further than the CFTC’s own enforcement program to see a principles-based regulator making an astounding impact in stamping out fraud and manipulation.

It is true that using a principles-based approach to regulation encourages a more collaborative relationship with the regulated entity but when improper activity occurs, this collaboration on the front-end must be complemented with strong enforcement on the backside. This “bookends philosophy" is a powerful approach in preventing and deterring wrongful activity in the industry. It is also important to recognize that principles do not affect how wrongful activity is defined. Fraud, manipulation, false reporting and trade practice abuse are well-defined legal concepts in statute and case law that are not affected by the transition to principles. Most principles focus on ensuring that the controls and processes are in place to prevent such wrongful activity. However, the definitions of such activity are unaffected by the new approach. So, even within our principles-based regulatory approach at the Commission, a strong enforcement program is a necessary component to market regulation and given the recent results of our program, I am confident that our markets are being well policed.

It is this complement of flexible principles-based oversight with real-time enforcement that makes the "smart" regulation idea effective. I call it prudential regulation with a bite or as Teddy Roosevelt made famous, we walk softly and carry a big stick.

Indeed the numbers are impressive. During the past five years, the Commission has filed a total of 295 enforcement actions and obtained more than $1.8 billion in total monetary sanctions including restitution, disgorgement, and civil monetary penalties. As hedge funds have become the investment vehicle of choice for many large investors, the Commission has ferreted out those operations that use fraud and deceit. In the last seven years, the Commission filed a total of 61 enforcement actions alleging misconduct in connection with commodity pools and hedge funds and has obtained a total of more than $231 million in penalties through these actions.

The energy markets are a particular area in which the Commission's enforcement program has effectively wielded a big stick. Protecting these markets is vital to our national interest because of the direct impact of energy price manipulation on consumers and the economy. From December of 2002 through October of 2007, the Commission filed 39 enforcement actions, charging 64 companies and individuals with attempted manipulation, manipulation and/or false reporting. To date these actions have resulted in civil monetary penalties of more than $434 million. And these defendants are some of the biggest players in the industry, including BP and Enron. We may be a relatively small federal agency, but we maintain a zero tolerance policy toward anyone who attempts to manipulate or disrupt the pricing in these important markets.

In this vein, I want to highlight the recent enforcement case against BP, which resulted in the largest manipulation settlement in our Commission's history. The investigation, jointly brought by the CFTC and Department of Justice, revealed that BP manipulated the segment of the propane market used for residential and commercial heating in the Northeastern United States in February 2004 and attempted to manipulate that market in April of 2003. The investigation revealed that BP employees claimed to "control the market at will," allowing BP to dictate prices to other market participants in order to obtain a significant trading profit.

In settling the Commission's charges, BP agreed to pay $125 million in civil monetary penalties and $53 million into a restitution fund intended to return money back to victims. The settlement was one of this agency's most comprehensive and was designed to not only punish past behavior at BP, but to ensure that market misconduct does not happen again. As part of the agreement, BP agreed to establish a significant compliance and ethics program and to install an independent monitor to oversee BP's trading activities. There were also criminal aspects to the case, which BP settled with the DOJ by paying $100 million in criminal fines and $25 million into consumer fraud fund. The total monetary sanction to BP as a result of its massive fraud was $303 million. Now that is what I mean about a big stick.

I have focused a lot on the success of our enforcement program. But uncovering unlawful conduct after the fact is not enough; we must also strive to prevent manipulation before it occurs on our markets. Thankfully, with the passage of the CFMA, Congress had the foresight to provide this agency with the tools needed to oversee this rapidly changing marketplace. Much has been made of the flexibility provided businesses by the CFMA, but the adoption of a core principles approach equally enhanced the Commission's ability to get in front of developing regulatory problems.

That said, regulators and lawmakers cannot anticipate every evolution of these markets.
The CFMA created a tiered regulatory structure for the futures industry, which tailored requirements to the specific risks of the marketplace. Within the tiered design, Congress created a light-touch regulatory category called Exempt Commercial Markets or ECMs, on which certain commodities, such as energy products, could be traded by institutional participants. Due primarily to the non-retail nature of these markets and the types of transactions executed, policymakers believed the risks associated with these wholesale exchanges were low.

However, the energy markets have changed dramatically in the past seven years and the Commission's regulation of these markets should evolve in kind. Although these exempt markets have increased competition, certain energy contracts offered on ECMs now function as virtual substitutes for contracts listed on regulated exchanges.

In September, the Commission convened a hearing to examine the oversight of trading on ECMs. Commission staff, exchanges, ECMs, and industry and consumer groups, including ISDA, testified before the Commission in a productive debate. Testimony from the Commission's hearing led us to conclude that certain natural gas products on the InterContinental Exchange (ICE) and New York Mercantile Exchange (NYMEX) function as virtual substitutes. Not only are the products substantially identical in terms and pricing, but the market participants are also the same with all of the top 25 natural gas traders on NYMEX also trading significantly on ICE. Moreover, economic analysis by our staff indicates that the trading activity in these products on ICE serves a significant price discovery function on 20 percent of the trading days measured.

Nevertheless, many witnesses from the hearing testified that ECMs provide a valuable platform for markets seeking a low-cost, effective "on-ramp" to launch new ideas for contract design and trading. However, the reality that some ECM contracts are serving a significant price discovery function led the Commission to conclude that changes to our act were necessary.

In October, the Commission presented a report to its Authorizing Committees in Congress detailing our findings and recommendations regarding these energy markets. In our report, the Commission recommended that the CEA be amended so that when an ECM futures contract is determined to serve a significant price discovery function, the Commission would have the authority to: 1) Require large trader position reporting for that contract, 2) Require an ECM to adopt position limits or accountability levels for that contract, 3) Require an ECM to exercise self-regulatory responsibility over that contract in preventing manipulation, and 4) Exercise emergency authority regarding such transactions.

These recommendations will allow the agency to properly oversee price discovery contracts while keeping in place the tiered regulatory structure that has fostered innovation and competition in these global markets. The President's Working Group on Financial Markets

(PWG), of which I am a member, was fully engaged in the development of these recommendations by the Commission and supports these measured changes to the law. I am hopeful that Congress will act quickly on this proposal as well as the CFTC's reauthorization and funding to ensure that these markets are being properly overseen and policed.

The CFTC report also recommends the formation of an Energy Markets Advisory Committee. It is my hope that this committee, which will be formed within the coming months, will be a forum for those with knowledge of the energy markets, including producers, distributors, market users and consumers, to come together and discuss emerging issues in the energy markets. Also, I have convened an internal Energy Markets Working Group among CFTC staff that will serve as a clearinghouse for cross-divisional knowledge within the agency as we regularly come together to share expertise and information in an effort to keep pace with the markets.

I will close by stating the obvious: the growth and complexity of the global derivatives business presents a challenge for regulators. But it is the flexibility provided by a principles approach to regulation, complemented by real-time enforcement, that has allowed the CFTC to effectively police the marketplace while encouraging innovation and growth in the derivatives industry. But the numbers speak for themselves. From the passage of the CFMA in 2000 to present, the notional value of over-the-counter derivatives transacted in the U.S. has grown by 276 percent. Over that same period of time, volume on the U.S. futures exchanges has grown 442 percent.

By all measures, the U.S. derivatives industry has enjoyed enormous success under this progressive regulatory regime. But equally important is the fact that it hasn't come at the expense of this agency's strong enforcement program and its ability to wield a big stick in protecting the integrity of the marketplace. Again, thank you for having me speak today on this important topic.