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Keynote Address

Keynote Address of
Acting CFTC Chairman Walt Lukken

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Thank you, Dean Sodano, for that introduction. It is a pleasure to be here at Hofstra University's first FOREX Symposium. And thank you to the *Journal of International Business and Law*. I commend the *Journal* for hosting this event and for the work it does exploring the interaction between business and law in the global marketplace. Globalization has been one of the driving forces in the expansion of the futures industry, and I take a particular interest in these issues.

As this audience knows, foreign currency trading is the largest financial market in the world, with average daily trading volume of approximately $3.2 trillion. Operating 24 hours a day, governments, central banks, Wall Street institutions, insurance companies, and corporations all use the inter-bank currency markets to manage the risks associated with fluctuations in currency rates. A properly functioning foreign currency market is critical to the well-being of the world's economies. In recent years, retail customers have also looked to forex trading as an alternative investment opportunity. As such, I applaud Hofstra University for hosting this event aimed at educating practitioners, market participants and consumers about these markets and at ensuring they remain functioning properly and free from fraud.

I have been a Commissioner at the Commodity Futures Trading Commission since 2002 and was recently named Acting Chairman in June 2007. My short tenure in this role has been with the stark backdrop of the extreme volatility and uncertainty in the world's financial, equity, and credit markets. These turbulent market conditions began last summer with the credit crunch rooted in the failures of the sub-prime mortgage and securitization sectors – two sectors that until recently were flying high. The quick and dramatic about-face in these markets should be a reminder to us all that good times can quickly turn bad in the face of complacency and lax standards and practices. Regulators and market participants must always guard against this to ensure that markets continue to operate well and compete effectively in the global marketplace.

Before I launch into my discussion of the CFTC's role in the foreign currency markets, it is important that I discuss what we do at the CFTC and how we do it.

I assume that in your off-hours when you're not debating the intricacies of financial markets, many of you may spend some time across the street at Chrebet's – the bar and restaurant owned by former NFL star and Hofstra alum Wayne Chrebet. I think it's reasonable to say that the CFTC strives to be the Wayne Chrebet of the financial regulatory world. We're one of the smaller and lesser-known federal financial regulators. However, our commitment to ensuring the integrity of the markets has allowed the agency to become a tenacious and highly effective leader in financial regulation.

The CFTC is an independent federal agency established in 1974 with jurisdiction over trading of commodity futures and options. The CFTC is the sole federal regulator responsible for overseeing the futures markets by encouraging competitiveness and efficiency, ensuring market integrity, and protecting market participants against manipulation, abusive trading practices and fraud. Through effective oversight, the CFTC enables the commodity futures and options markets to serve their vital function in the nation's economy – providing an effective marketplace for price discovery and risk management.

Back in the early days, much of our focus was on agricultural commodities. While agricultural commodities remain an important focus, the markets are now primarily financial with over 85 percent of the industry's volume. During the past 10 years, trading volume on U.S. futures exchanges has quintupled and reached 3.2 billion contracts last year. Today, in a single day of trading, our markets will trade contracts valued at more than $5 trillion in notional value. The sheer number of instruments listed for trading has grown in like fashion. Prior to 2000, the number of contract types traded was relatively stable at a level of around 250. In 2008, we expect the number of actively traded contracts to climb to a record high of nearly 1,600.

In the face of the evolution and growth in our industry, the CFTC achieves its mandate by employing a well-trained and dedicated staff who works within three major programs – Market Oversight, Clearing and Intermediary Oversight, and Enforcement.

Market Oversight ensures that the futures markets are operating efficiently and without manipulation and fraud. They do so by first reviewing and analyzing the very diverse group of instruments and products to ensure that they are not susceptible to manipulation. Market Oversight staff also conducts active market and trade practice surveillance of trading activity on designated contract markets, also known as "DCMs". A nearby example of a DCM is the New York Mercantile Exchange.

Traders establishing positions on DCMs are subject to reporting requirements so staff can evaluate position sizes to detect and deter manipulation. Every day, for the estimated 1,400 active futures and option contracts in the U.S., Market Oversight staff can monitor the activities of large traders, key price relationships, and relevant supply and demand factors to ensure market integrity.

In addition, CFTC surveillance economists prepare weekly summary reports for futures and option contracts that are approaching their expiration periods and advise the CFTC Commissioners and senior staff of significant market developments so they will be prepared to take action if necessary.

The Division of Clearing and Intermediary Oversight ensures the financial integrity of all transactions on the markets that we regulate. The work of the staff is to ensure that the intermediaries managing these funds are properly registered, perform appropriate recordkeeping, have adequate capital, employ fair sales practices, and protect the funds their customers invest. Intermediaries overseen by the CFTC include some 200 futures commission merchants, including banks and broker-dealers with specialized futures operations, as well as stand-alone futures trading houses.

Finally, the CFTC prides itself on its vigorous enforcement operation. At any one time, the Division of Enforcement is investigating and litigating with approximately 700 to 1000 individuals and corporations for alleged fraud, manipulation, and other illegal conduct. During the last five years, Enforcement has maintained a record level of investigations and prosecutions in nearly all market areas, including manipulation, attempted manipulation, false reporting, hedge fund fraud, and off-exchange foreign currency fraud.

The CFTC's Division of Enforcement investigates and prosecutes violations of the federal laws governing commodity trading by individuals and firms who are engaged in activities that directly or indirectly affect commodity futures and option trading on domestic exchanges. These federal laws prohibit fraud and abusive practices in solicitations of futures or options, such as falsely guaranteeing profits, minimizing risk, and misrepresenting performance history. In addition, the CFTC is authorized to bring enforcement actions for misappropriating customer funds, and often refers matters involving egregious fraud to criminal authorities. Manipulation, fraud and other violations of the Commodity Exchange Act undermine the integrity of the markets and the confidence of market participants, and are not tolerated.

These three critical CFTC programs have been instrumental in allowing the CFTC to adapt and respond to the rapid changes in our industry. I have no doubt that we will continue to do so.

The CFTC's ability to adapt comes largely from its unique principles-based regulatory approach. In December 2000, the Commodity Futures Modernization Act ("CFMA") was enacted, establishing the flexible, principles-based regulatory regime that the CFTC operates under, and under which our industry has flourished.

In general, a principles-based approach requires regulated entities to meet certain high level principles in conducting their business operations. Under this approach, both exchanges and clearing houses must meet a separate set of statutory "core principles" and must continually adhere to them. For each principle, the agency may set out acceptable practices that serve as safe-harbors for compliance. With few exceptions, there are no longer prescriptive regulations that dictate the exclusive means of compliance. Rather, exchanges have the choice of following CFTC-approved acceptable practices or adopting their own measures for complying with the overarching principle.

Such an approach has the advantage of being flexible for both the regulated and regulator. As technology and market conditions change, exchanges may discover more effective ways to meet a mandated principle. Although the regulatory mission remains static over time, the means for achieving it evolves as innovation occurs or circumstances change.

A second advantage to principles regulation is its focus on risk. Risk-based regulation is advantageous because it inherently requires regulators to incorporate cost-benefit judgments into their decision-making. This gives greater certainty that both industry and public funds are utilized appropriately. This approach also provides greater incentive and accountability for firms in managing their risk in a more comprehensive and qualitative manner, instead of relying on a checklist of rules promulgated by a regulator.

Principles-based oversight also has a significant advantage because it drastically enhances the regulators' ability to work cooperatively with other regulators around the world. This is critical given the realities of the 24-hour, global marketplace that we all operate in. For this reason, several jurisdictions worldwide have adopted the principles-based approach, including the UK and Australia, with other nations seriously contemplating its implementation in the near future.

These days, there is concern that New York City may be losing its position as preeminent global financial center. Independent studies – sponsored by the Chamber, the Committee on Capital Markets Regulation and New York Mayor Bloomberg and U.S. Senator Schumer – assert that U.S. stock markets may be losing ground globally. In response, Treasury Secretary Paulson and his staff are currently preparing a regulatory blueprint with suggestions for modernization of regulation of the U.S. financial industry that is expected out in the spring.

Since the CFTC moved to a flexible principles-based approach, volume on the U.S. futures exchanges has grown 443 percent. Today, the largest U.S. exchange is not located in New York but in Chicago with the CME's market capitalization recently near $35 billion. By many measures, the U.S. futures industry has enjoyed enormous global success under this progressive regulatory regime.

In addition to creating this structure, the CFMA clarified the CFTC's jurisdiction in the area of off-exchange foreign currency futures and foreign currency options trading. While there are legitimate operators in the retail forex business, the CFTC has witnessed a large and growing number of corrupt individuals and firms that defraud innocent victims in foreign currency scams. These con artists often misappropriate the funds invested, either paying them out to earlier investors – typical of a Ponzi scheme, or using the funds for their personal expenses.

The end of the story is typically not a happy one – the customer is told that the market turned against him and his investment is gone; or the firm will disappear and efforts by the customer to contact it will be unsuccessful. The CFTC's investigations and enforcement actions have revealed that many times the "scam artists" did not even invest the customer's funds in foreign currency trading but instead stole the funds and used them to support a lavish lifestyle. Unfortunately, forex telemarketers often focus their pitches on some of the most vulnerable citizens, such as retirees.

Why has this fraud blossomed and who is there to police this activity? The Commodity Exchange Act generally requires that the trading of all futures contracts occur on a registered futures exchange under the exclusive jurisdiction of the CFTC. This regulatory structure was designed for the traditional "open outcry" exchanges to ensure that standardized futures trading occurred in specific physical locations under the watchful eye of a federal regulator. This regimented oversight also took aim at off-exchange "bucket shops," in which individuals would fraudulently solicit funds from customers for futures trading and then pocket or "bucket" the money. Requiring that futures trading occur on a registered exchange among registered brokers greatly minimized this illegal activity.

However, the Commodity Exchange Act treats foreign currencies differently than other financial commodities. At the behest of the Department of Treasury during the formation of the Commodity Exchange Act in 1974, certain off-exchange foreign currencies were excluded from the CFTC's jurisdiction because the Treasury Department believed that the inter-bank currency market and its sophisticated participants did not need the additional protections offered by the Act. The scope of the "Treasury Amendment," as it became known, and subsequent court cases interpreting the meaning of this provision, made it difficult for the CFTC to bring fraud actions against off-exchange foreign currency scams aimed at retail customers.

In clarifying this jurisdictional uncertainty, the CFMA in 2000 adopted language generally excluding from the CFTC's oversight foreign currency transactions not transacted on a registered futures exchange. However, where off-exchange retail foreign currency futures or options transactions are offered, the Act clarified that the CFTC does have jurisdiction unless the offering firm is an "otherwise regulated" entity (such as a bank, a broker-dealer, a financial or investment bank holding company, or an insurance company). The Act further clarified that the CFTC's anti-fraud authorities apply to off-exchange foreign currency transactions that futures commission merchants (FCMs) and their affiliates enter into with retail customers. These changes temporarily plugged the loophole that had allowed off-exchange retail foreign currency bucket shops and boiler rooms to exist and flourish.

Since 2000, the CFTC has aggressively pursued forex fraud through enforcement actions and cooperation with local, state and federal criminal authorities. We have successfully shut down firms, frozen assets, and assisted in criminal prosecutions that have led to significant jail time for violators. In the last seven years, the CFTC has brought 98 enforcement actions involving forex fraud against unsuspecting retail customers committed by more than180 firms and nearly 200 individuals. In these 98 cases, there were approximately 26,000 victims who invested approximately $461 million. Courts have awarded more than $1 billion in customer restitution and civil penalties in these cases.

In 2004, however, the Seventh Circuit Court of Appeals curtailed the Commission's ability to combat retail off-exchange forex fraud in the *Zelener* case. Moreover, in 2007, the Sixth Circuit Court of Appeals likewise limited the Commission's ability to combat forex fraud in the *Erskine* case. In both cases, the Courts held that the contracts at issue were not futures contracts, but rather were a type of rolling spot contract that was not subject to the CFTC's jurisdiction. While both decisions concluded that fraud had been committed, the courts dismissed the cases as not properly within the CFTC's jurisdiction.

These cases provide a potential road map to scam artists as to how to deceive innocent retail customers while evading enforcement by the CFTC. These decisions have weakened our ability to protect the public and the legitimate forex industry from fraudsters. The CFTC believes that these cases were incorrectly decided and that the contracts at issue are futures contracts subject to the CFTC's anti-fraud jurisdiction.

Because of *Zelener* and decisions that followed its reasoning, the CFTC has lost some recent key forex cases and now finds it more difficult to prosecute these activities. In response, a lot of legislative work has been done to restore legal certainty to this area of CFTC jurisdiction. The

President's Working Group on Financial Markets, which includes the Chairman of the CFTC, the Chairman of the SEC, the Secretary of the Treasury and the Chairman of the Federal Reserve, has recommended changes to legislatively close the oversight gaps caused by these cases. The proposal would require those who participate in the solicitation of retail forex transactions to register with the CFTC. It would also close the loophole that allowed firms to notice register as securities broker-dealers and serve as counterparties to off-exchange forex transactions. Last, the proposal would bolster the CFTC's antifraud authority over retail off-exchange forex transactions like those in dispute in the *Zelener* case. This language passed the Senate as part of a broader CFTC reauthorization amendment to the Farm Bill. In addition, the House Committee on Agriculture has passed a CFTC reauthorization bill that includes these provisions but also adds certain capital requirements for institutions dealing in foreign currency transactions. We are hopeful that Congress comes up with a final Farm Bill in the near future that will reauthorize the CFTC and resolve the forex fraud issue.

However, at the end of the day, no matter how many court cases the CFTC wins, or whether Congress overrules these bad court decisions, the CFTC's enforcement efforts can only do so much. The first line of defense for consumers is education. The CFTC has done a great deal in this area. The CFTC Forex Public Outreach and Education Task Force, led by Commissioner Mike Dunn, seek to alert and educate members of the general public about the growing epidemic of fraudulent retail forex solicitations. This group also encourages state, local and federal authorities, as well as consumer advocacy groups and industry organizations, to assist our efforts in fighting forex fraud. The Task Force's activities include: participation in the creation of the CFTC's New Forex Brochure, working cooperatively with the North American Securities Administrators Association and the National Futures Association (NFA), and engaging in local, national and international Media Outreach.

Just as important is the CFTC's continued work with federal, state, and local criminal authorities through our cooperative enforcement office. It is our view that egregious fraudulent activity should be prosecuted criminally. When fraud is clear, prison time serves as a powerful punishment and deterrent for these recidivists and we will seek criminal charges with the proper authorities when the wrongful activities justify such a response.

In closing, I would say that I am optimistic about making progress—either through reauthorization, enforcement or education—to ensure that foreign currency fraud is minimized in our nation and that legitimate interests may be able to prosper and grow in these markets. I hope that the industry and agency can work together in the coming year to meet these challenges. It's a dynamic industry during a dynamic time and it's a privilege to play a role in it. Thank you for your time and for asking to me to speak to you today.