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Speech

Building Regulatory Networks
CFTC Acting Chairman Walt Lukken
(As Prepared For Delivery)

FIA Annual Conference
Boca Raton, Florida
March 13, 2008

I want to thank the Futures Industry Association (FIA), Richard Berliand and John Damgard for inviting me to speak this morning. I am grateful that the CFTC can join this event by holding our own foreign regulatory conference, which occurred yesterday. The synergies created by these two conferences enable a more robust dialogue between regulators and the industry, which benefits all involved. Thank you, John and Richard.

These are extraordinary times for our markets. Commodity prices are at unprecedented levels that have not been experienced since the last World War. These higher prices have been caused by both macro-economic factors as well as micro fundamentals for given markets. Broadly speaking, the falling dollar, strong demand from the emerging world economies, Mideast political unrest, detrimental weather and ethanol mandates have driven up commodity prices across-the-board. On top of these trends, the emergence of the $500 billion plus sub-prime crisis last summer led investors to the liquidity, safety and positive returns that commodity futures provide. All U.S. exchanges have experienced record volume and settlements during this time period, including one day in January in which the CME cleared and settled more than $12 billion worth of transactions—nearly six times its normal load. Needless to say, this is rarified air we are currently breathing.

Despite these levels of prices and volume, the price discovery and risk management functions of our markets and the plumbing of the clearing system have worked extraordinarily well. Not surprisingly, however, this stress in the markets has caused some cracks to appear. Just two weeks ago, the news broke that an employee at MF Global incurred over $140 million of trading losses overnight while trading wheat futures. And of course, you are all well aware of the recent discovery of extraordinary, multi-billion dollar trading losses at Société Générale. In both of these cases, the facts are still being uncovered, so we will have to wait to draw final conclusions.

Even so, these recent situations are a clarion call that should prompt us to consider the lessons we can learn from these unfortunate events.

I have asked FIA to review the 1995 report on risk controls that it produced in the wake of the Barings crisis to determine whether the findings should be updated given the current crises du jour. It is our collective responsibility, both industry and regulator, to remind ourselves of the dire consequences when risk controls go lax. We must remain diligent on this front.

Because it is easy to get bogged down discussing crisis management when such episodes occur, today I want to look at the broader picture for our agency. I recently took my four year old son to the Smithsonian National Gallery of Art. This led us to the Impressionist wing where he went running uncomfortably close to a famous Monet painting. His comment to me was, “Daddy, this painting doesn’t make sense…it is just a bunch of dots.” But as I moved him back from the painting to my relief and that of the nearby guard, the light bulb had gone on for him and Monet’s Houses of Parliament came into view. Sometimes distance provides perspective.

Today I want to take a step back and talk about a few of the strategic goals that this agency will pursue in the coming year. I have spoken about “smart regulation” in the past, which attempts to instill a culture of compliance through the use of flexible, risk-based regulation. But today I want to hone our focus on the importance of networks in the furtherance of our regulatory mission.

Networks are an integral part of today’s digital society. We are all familiar with social networks like Facebook and You Tube, communication networks like email and Internet blogs, and economic networks like eBay and for that matter, electronic exchanges. All of these networks have fundamentally impacted our daily lives and exist for a common reason--bridging like-minded individuals together to communicate information and ideas for the betterment of the individual as well as the network as a whole. In a relatively short period of time, technology has fundamentally changed the manner and speed in which humans interface with each other.

To take advantage of the data and analytics to oversee this industry, the CFTC must think in terms of regulatory networks, which require substantial investments in two items: technology and relationships. I will significantly advance both items during my tenure.

Technology:

The CFTC uses technology primarily in the surveillance of markets and the monitoring of the financial integrity of clearing organizations and firms. Accordingly, the agency is pouring significant amounts of its capital into modernizing our surveillance network, which will pay off with enhanced market transparency and detection tools for CFTC staff. This year the agency will increase technology personnel by 25 percent with the hope of nearly doubling the overall technology budget by next year.

One of the CFTC’s most critical missions is to detect and prevent price manipulation. The centerpiece of the CFTC’s market surveillance program is its technology-dependent large trader reporting system. All futures commission merchants (FCMs) must report daily trade positions to the CFTC, which are above a certain trading threshold.

This amount and detail of trade data collected and analyzed at the CFTC is unprecedented among regulatory agencies. The CFTC staff not only monitors daily positions of all large traders, but also has the ability to look at the minute-by-minute trades of these market participants during times when there is a heightened risk of manipulation, such as end-of-day trading periods. This system also allows staff to quickly look at the positions of traders for a given contract listed on multiple exchanges, such as the linked natural gas and oil contracts trading both on NYMEX and ICE. Where previously it would have taken weeks to obtain and assess a particular trader's daily positions, including those positions across markets, we can now perform that same analysis in less than a minute. And soon, we will have the capability to monitor and analyze a trader's intraday trading activity virtually in real-time.

Two weeks ago, the CFTC and Actimize, a leading provider of transactional risk management technology for the financial services industry, announced a major partnership for the further development of our trade practice surveillance network. The new trade practice system will automate basic trade surveillance as well as perform timely and customized analyses of all trading activity. Significantly, this system will facilitate the detection of trading abuses across multiple exchanges, a function that only the CFTC can perform.

As we all know, the format of the data is as important as the technology itself. With the help of the exchange and trader communities, the CFTC hopes to foster the development of an industry standard for exchange data through the enrichment of the existing FIXML data tagging format. With CFTC encouragement, a futures industry data committee is expected to propose changes to the international body that sets such standards in the near future. In addition, the agency is exploring the greater use of XBRL, which is another data standard for financial statements. It is my hope that, by speaking the same data language, network synergies will develop as regulators and market participants are better able to communicate and add value and functionality to their information systems. I strongly support such efforts.

Relationship Regulation

In addition to technology networks, there exists a second critical network that can sometimes be overlooked in this brave new cyber-based world—and that is the human network. Collaboration and relationship-building in a flat world is absolutely necessary in order for government authorities to do their job. Regulators must stay engaged with each other in order to make informed decisions for the public good.

No matter the size of the agency, individual regulators do not have the resources to sufficiently monitor the breadth of the global marketplace. We must rely on the expertise of other regulators, both domestic and foreign, in fulfilling our public mission. These relationship-building efforts begin close to home with my membership on the President's Working Group on Financial Markets. Led by the Secretary of the Treasury and consisting of the Chairmen of the Federal Reserve, SEC and CFTC, the PWG meets regularly to share information and ideas about today's inter-related marketplace. The synergies created by such collaboration are significant and prove vital in times of market stress.

As the evolution of the securities and futures markets continues, one of our most important regulatory relationships is with the SEC and there is much work we can do to rationalize our differing approaches to regulation. Earlier this week, the SEC and CFTC took a historic step in improving and formalizing our regulatory coordination of the marketplaces we oversee. With our Commissions' support, Chairman Cox and I signed a memorandum of understanding (MOU) that will help the agencies share information as well as coordinate our review of novel derivative products that have attributes of both securities and futures. We took the MOU out for its first ride by seeking public comment on two gold ETF products to be listed by OneChicago and CBOE. As a longtime proponent of principles, I am pleased with the MOU's inclusion of principles that will guide the agencies when addressing future novel derivative products.

These principles reaffirm the importance of encouraging product innovation, market neutrality, competition, and legal certainty, consistent with the agencies' respective regulatory schemes. Additional topics we plan to tackle under this agreement include portfolio margining and foreign equity indices. Like all relationships, this one will require work and there will be bumps in the road but Chairman Cox and I are committed to further rationalizing our differing regulatory structures using this agreement as a roadmap going forward.

When we're not busy collaborating with the SEC, we are likely coordinating with FERC on our respective enforcement missions. The CFTC and FERC stand shoulder to shoulder in the U.S. government's efforts to ensure that the energy markets remain free from manipulation. Both Chairman Kelliher and I have respectfully acknowledged that the agencies have a difference of legal opinion on interplay between the CFTC's exclusive jurisdiction and the FERC's new enforcement powers, which will likely be resolved by the courts. Despite these differences, we both recognize the growing need for our agencies to cooperate in overseeing these markets within the bounds of our legal authority. With Congress' recent grant of manipulation authority to the FTC for petroleum products, the CFTC has also reached out to the FTC to open a dialogue regarding our respective enforcement mandates in order to coordinate our investigative programs and to avoid duplication of effort.

The importance of these relationship networks extend beyond our borders. The CFTC has long been an international leader in coordinating its efforts with its foreign counterparts. The CFTC was one of the first to embrace the "mutual recognition" concept for foreign jurisdictions dating back twenty years for foreign brokers and ten years for foreign exchanges. The agency is a leading member of the International Organization of Securities Commissions (IOSCO) where international standards and ties are strengthened.

One important foreign partner worth highlighting is the United Kingdom's Financial Services Authority, given our similar principles-based regulatory schemes and our oversight responsibilities of linked crude oil products. By strengthening this relationship over the last several years culminating with a groundbreaking MOU on market surveillance, our agencies have set a sound precedent for other foreign regulators as they seek to create a borderless global regulatory network. Such international ties are critical if the world's regulators are to be effective in policing the global marketplace.

Before closing, I would like to step a bit closer to the canvas for a moment to mention a couple of the items on the agency's immediate "To Do" list.

It is my hope that in the coming days the CFTC will publish a concept release on the proper regulatory treatment of event contracts and markets. Event contracts are generally structured to direct a given payout when a certain event occurs, such as the Consumer Price Index exceeding 5 percent, the Dow surpassing 15,000 or a particular candidate being elected President of the United States. Given the Commodity Exchange Act's purpose of promoting price discovery and risk management through hedging, fundamental questions must be answered: Is it appropriate that we regulate these event contracts and markets, and if so, in what manner? Does an event contract need to have an economic purpose in order to invoke the CFTC's jurisdiction? How do we distinguish these contracts from pure gambling? The CFTC is evaluating how these markets should develop and how to ensure that the proper protections are in place. I encourage this industry to provide us with your informed views on this concept release once it is published.

The CFTC also will move to finalize its proposal on self regulation and corporate governance conflicts of interest. Independence in exchange self-regulation and governance is significant to ensuring these public markets are regulated and functioning properly. I hope that the CFTC will republish this proposal with clarifications to the definition of "public director" in the near future.

Energy and enforcement will always remain a focus, especially given the current market conditions. With the recent BP manipulation settlement as proof, the CFTC is fortunate to have one of the premiere derivatives enforcement programs in the world. The success of this program is largely due to the great work of our enforcement division under the leadership of Greg Mocek. During his six years at the helm, the Commission has assisted criminal authorities in locking up over 200 offenders and obtained more than $2 billion in fines and restitution—much of this levied against those who believe they can manipulate the energy markets. With the price of oil above $100 a barrel and its gravity pulling the entirety of the energy sector higher, the CFTC and its enforcement program will continue to maintain a zero tolerance policy toward anyone who attempts to manipulate or disrupt the pricing in these important markets.

Also on the energy front, the Commission recently formed the Energy Markets Advisory Committee (EMAC), which was a recommendation from the CFTC's Exempt Commercial Market report last fall. Still in its early formation stage, the EMAC will consist of a good cross-section of stakeholders in our industry and the public, and it is meant to improve dialogue among those involved in, and affected by, the energy trading business. We have had an outpouring from groups wanting to participate, and we hope to have our first meeting in the next several months.

I'll quickly mention that the CFTC's reauthorization is still pending but nearing finalization. The legislation, which is part of the larger Farm Bill conference, would authorize the CFTC for five more years and provide the agency with additional authority for significant price discovery contracts traded on exempt commercial markets, such as the InterContinental Exchange. The bill also would clarify the CFTC's fraud authority over retail foreign currency trading, where we have witnessed a plague of scams in recent years. The passage of CFTC reauthorization legislation would be a significant accomplishment for this agency, and I am pleased that Congress is nearing its completion.

In closing, I would say that I learned some valuable lessons that day at the art museum with my son. First, never trust a four year old with priceless art. Second, and more importantly, stepping back is imperative for gaining perspective. I strongly believe that the CFTC is well positioned going forward to meet domestic and global challenges. Our current progressive regulatory scheme will dramatically benefit from advancing these relationship and technology networks in an effort to more effectively accomplish our critical mission. However, networks and technology alone cannot take the place of solid judgment. That is why conferences such as these are so important for helping regulators understand the industry they oversee so we can make informed decisions and advance the public interest. FIA is an important partner on this front and I appreciate your inviting me to speak here this morning.