Commodity Futures Trading Commission
Office of External Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Keynote Address

Keynote Address of Acting Chairman Walter L. Lukken Before FIA Futures and Options Expo, Chicago, Illinois

(As Prepared For Delivery)

November 11th, 2008

I appreciate the Futures Industry Association for inviting me here to speak today as we celebrate and honor our country's military veterans—those brave individuals who have valiantly served this nation in time of war and peace. We give thanks for their service and for the life and liberty that they preserve for all Americans.

Last week, voters in record numbers participated in an historic election in which this state's celebrated son, Barack Obama, was elected to the nation's highest office. As President, he will have a shorter honeymoon period than most, given the situation currently facing this country and its economy. But I am optimistic that President-elect Obama will work together with both parties to find sensible solutions to our nation's problems and economic ills. All Americans should wish him the greatest success in uniting this country in pursuit of common goals and ideals.

Every four years, an amazing occurrence happens in our nation's capital as citizens and politicians gather and put aside their differences to celebrate the peaceful transition of power from one administration to the next. The Presidential Inauguration is a bipartisan-planned event that occurs without party distinctions or biases. Like rival siblings, during this period, we lay aside our disagreements and celebrate as one American family. As inaugurations have become routine, we often take this transition for granted. But it's this routine nature that makes it awe-inspiring as the outgoing President hands over the leadership of the most powerful and wealthy nation on earth in celebrated pride for the rule of law. Respect for the democratic process makes the United States the envy of other nations around the world who do not have the luxury of a free and representative government where political differences can be aired and debated without fear of retribution. It is this liberty and freedom and these democratic ideals we celebrate as a nation every four years.

The CFTC will also face a transition with the coming Administration. As Acting Chairman of the CFTC, I serve under the nomination of the current President and do not intend to stay in the role of Acting Chairman past the inauguration. I also intend to leave the Commission shortly after stepping aside as Acting Chairman to provide others with an opportunity to serve the public. I am looking forward to helping the new Administration with this transition over the coming months.

The Commission has accomplished a great deal over the last year during these trying economic times and what a year it was. The agency held eight public hearings, including an agricultural roundtable that drew 2,800 website viewers from 38 states and 43 countries. And as commodity prices soared, I testified 14 times to various House and Senate Committees on speculation and other related topics. After years of effort, the CFTC was finally reauthorized in May, thus closing the "Enron Loophole" and bringing more oversight to the energy swaps markets. And as spring turned to summer, the Commission took action to increase transparency and controls on foreign boards of trade that list products linked to U.S. markets. Summer included the formation of an interagency working group with other federal regulators to study the commodity markets and the role of speculators. And fall began with the Commission publishing its Swap Dealer Report, providing unprecedented transparency on the size of off-exchange commodity index trading. On top of all of this, our Division of Enforcement pursued its national crude oil, cotton and silver investigations—along with dozens of others—and filed 40 new actions, resulting in over half a billion dollars in penalties. Needless to say, it has been busy, and the hard-working staff of the Commission should be proud of their efforts.

But there remains much work to be done by the current and subsequent CFTC Commissions. Today I would like to discuss with you the challenges facing the financial services industry—and the futures industry in particular—and to outline what steps should be considered to restore the confidence of the investing public in our markets and the economy.

"Breathtaking" is the word that best describes the current financial crisis being felt around the world. The Dow Jones Industrial Average has declined 40 percent from its recent highs, now hovering around 9000—a mark it first crossed in 1997. In other words, investors have given back a decade of gains in just the last several months. Should stock and home prices remain at current levels, Americans will witness approximately a 14 percent drop in household wealth this quarter, the largest on record.

The "shock and awe" of the financial crisis has been equally matched by the government's response. Like the Powell Doctrine on military engagement, global governments have responded with "overwhelming force" to shore up the current banking systems. Along with the Federal Reserve's expansion of liquidity facilities and guarantees, the U.S. Congress has authorized $700 billion for Treasury to re-capitalize the banking system. Other countries around the world have followed suit with Germany having pledged 500 billion Euros, France 300 billion Euros, and the Netherlands with 200 billion Euros, just to name a few. As Federal Reserve Chairman Bernanke has testified, such an "overwhelming" response by government is needed to unthaw the credit markets and help minimize the length of the pending recession that now looks inevitable.

This type of financial panic and government response prompted the Washington Post a few weeks back to ask in its lead editorial, “Is Capitalism Dead?” As the markets reeled, the very foundation of our republic’s economic system was being questioned. As the taxpayer bill increases from this crisis, one has to question whether the free hand of Adam Smith’s teachings was really free at all.

I think this audience will agree with me that capitalism is not dead. The capitalist system has generated enormous amounts of global wealth and prosperity and increased the living standards of millions of impoverished citizens. And the futures markets have been a key driver in this prosperity. Over the last decade, we have seen exponential growth in our markets as trading has improved the ability of companies to manage risk, invest and allocate capital and create jobs. And throughout this crisis, the futures markets have continued to operate without major disruption. There have been no failed exchanges or clearinghouses, and customer funds have remained protected. With its principles-based regulatory structure, the core mission of the CFTC remains intact: protecting market users from abuse and overseeing the price discovery function of the regulated markets.

But in recent months we have also witnessed the distortions and dire consequences that can arise within the capitalist system when it is left with inadequate checks. From the lax lending standards in the housing sector to the unregulated over-the-counter derivatives that helped to fuel the credit binge, the current crisis has uncovered the substantive need for reform and created the political will to get it done. We must take the necessary steps to repair the financial system and regain America’s trust and confidence in our markets. It is precisely at this moment when courageous regulatory reform is most needed.

It is in this spirit that today I advocate a bold, new direction for our regulatory system. I believe the United States should scrap the current outdated regulatory framework in favor of an objectives-based regulatory system consisting of three primary authorities: a new Systemic Risk Regulator, a new Market Integrity Regulator and a new Investor Protection Regulator. This objectives–based framework is similar in concept to the reforms advanced by Treasury Secretary Paulson’s Blueprint and Paul Volcker’s Group of Thirty Report.

A new Systemic Risk Regulator would have the responsibility of policing the entirety of the financial system for “black swan” risks that could cause a contagion event and taking preventative action against such occurrences. Such a regulator does not exist in the current framework but is absolutely necessary given the witnessed interconnections of our financial markets and the speed of the current global crisis. A new Market Integrity Regulator would oversee the safety and soundness of key financial institutions, including exchanges, investment firms and commercial banks whose failure may jeopardize the integrity of the markets. A new Investor Protection Regulator would broadly oversee investor protection and business conduct across all firms in the marketplace. This objectives-based framework focuses on risks from the macro to micro levels and would be a radical departure from the current structure. The different functions of the CFTC, as well as the SEC and the various banking regulators, would be dispersed among these three regulatory authorities.

This objectives approach would significantly improve financial market transparency across-the-board, but most importantly in the current unregulated over-the-counter (OTC) markets. Regulation by objective rather than function will ensure that all products and institutions are properly overseen based on identified public risks rather than futile and difficult determinations of whether an instrument is a security, a future, or a swap contract. Under this approach, the Systemic Risk Regulator would have broad access to information from the entire marketplace to monitor concentrations of risk while the Market Integrity and Investor Protection Regulators focus more specifically on their respective missions.

This new structure would require certain reporting of exchange and over-the-counter market data to regulators, particularly when such products begin playing a public pricing role or when their size creates the risk of a systemic event. Clearly today's credit default swaps market, which has garnered so much attention lately, would meet this threshold. The resulting enhanced transparency would enable the Market Integrity and Systemic Risk Regulators to police the markets for misconduct and concentration of risk. In building such a framework, Congress might look to the model adopted in the Farm Bill for the OTC energy swaps market, which triggers additional oversight and transparency when a product begins to serve a significant price discovery function. Such an approach enjoys the advantage of allowing the over-the-counter market to continue to serve as an incubator model for product innovation and tailored risk management but would trigger additional oversight when certain public risks arise.

This broad restructuring must be preceded or accompanied by a complete rewrite and modernization of the laws and regulations governing the financial markets, including the securities and futures laws, to adopt a more consistent principles-based regulatory approach. One of the lessons from this crisis is that the current rules-based regulatory approach was not able to keep up with the speed and innovation of the financial markets. A principles-based structure complements tailored rules by adding needed guidance and flexibility to desired policy objectives. This helps prevent institutions from making end runs around static rules when such actions violate a broader public policy. The CFTC currently utilizes such an approach, coupled with strong enforcement, which has enabled the agency to keep pace with fast moving global markets.

The flexibility of a principles system also would help to manage the important but different missions of our current financial market regulators for futures, securities, and banking. For example, the CFTC is charged with promoting price discovery and risk management in our markets while the SEC upholds the important mission of investor protection and the banking regulators focus on the safety and soundness of depository institutions. As products converge, these differing missions can conflict and agencies are left attempting to balance the competing public interests. Simply placing these missions under one roof does not resolve the conflicts. A new objectives-based regulatory system, using a flexible principles approach, would provide new regulatory authorities with the tools and the structure to better coordinate and manage the critical but sometimes competing public missions that federal regulators must pursue to oversee broad financial markets, while avoiding the rules-based tripwires that bog down the current system.

One idea that has been put forth as both a permanent and interim reform step is a simple merger of the CFTC and the SEC. In Washington, this is code for the larger

SEC—along with its rules-based model and culture—taking over the principles-based CFTC. In my view, this would be ineffective and would only reinforce our outdated regulatory structure. Even if proposed as an interim step, the difficulty of a merger—both politically and substantively—would likely transform a provisional action into a final one. This would be a crucial lost opportunity because merger alone does not address the current problems that plague our economy or the shortcomings in our regulatory system. A merger would not have improved the lending standards for mortgages nor would it have addressed any of the problems in our housing markets, which are at the core of the current credit crisis. A merger would not have solved the debate over the impact of mark-to-market accounting. A merger would not have addressed the credit rating agencies nor changed the effectiveness of the consolidated supervised entity program. A merger would not have affected the lack of regulation for credit default swaps as both the SEC and CFTC are explicitly excluded from regulating these instruments by statute. To say that a merger would have prevented our current financial crisis is not accurate. Simple merger is a recycled idea when bold solutions are needed. If change is in the air, we should start from scratch with a new regulatory vision and not get caught up in the entrenched interests of the past.

The regulatory framework I have outlined today will take significant time to debate and implement—months maybe years. A thoughtful discourse is needed to work through the many complex details and to avoid unintended consequences in the markets and economy. Unfortunately, time is at a premium given the state of the volatile markets and some immediate steps are required.

To quicken the process of reform, I support the creation of a bipartisan select Congressional committee to study the way forward on financial reform. The formation of such a committee seems almost a necessity, given the multiple committees of jurisdiction on this topic. I fully support the idea, provided that the current committees of jurisdiction over the CFTC, the Agriculture Committees, are adequately represented. These committees have many years of experience with the risk management markets and the regulation of exchange-traded derivatives, and their input to the process is crucial.

As long term reform takes shape, policymakers also should consider the interim step of creating a unified regulatory board—consisting of the heads of the Federal Reserve, the SEC and the CFTC—that would facilitate the sharing of market information and be armed with joint rulemaking and exemptive authority to eliminate regulatory gaps and duplications that currently exist in the system. While each agency remains independent, this unified regulatory board would have the benefit of preserving the expertise of each agency while formalizing the coordination that is needed to oversee the entirety of the marketplace, including over-the-counter products. Another benefit of this board would be to provide the Federal Reserve with access to securities and futures market data—along with the OTC data from banks—that would enable them to immediately begin serving in the role of systemic risk regulator as Congress works on long term reform.

There are immediate steps that regulators should take to shore up the financial system and provide policymakers with some breathing room to thoughtfully consider reform ideas next year.

In the near term, regulators should continue to aggressively advance efforts by market participants to create a clearinghouse for credit default swaps. I am a strong proponent of these initiatives. Clearing brings enhanced transparency, standardization and risk management to these products at a time when it is most needed. As this audience knows, clearinghouses have been functioning for many years as a means for mitigating the risks associated with exchange-traded financial products. Whether for securities, options, or futures, centralized clearinghouses ensure that every buyer has a guaranteed seller and every seller has a guaranteed buyer, thus minimizing the risk that one counterparty's default will cause a systemic ripple through the markets. For futures contracts, clearing has worked extraordinarily well in managing credit risk. Importantly, no U.S. futures clearinghouse has ever defaulted on its guarantee. With our experience in clearing OTC derivatives, the CFTC will work expeditiously with other federal regulators to conduct our due diligence and approve those CDS clearing facilities that have met our high regulatory standards, including international central counterparty standards developed by IOSCO.

Immediate steps should be taken by global authorities as well. As this financial crisis has shown, the world financial system is highly intertwined, leaving no country's banking system unscathed. This week global leaders will meet in Washington D.C. as part of the G20 to discuss broad principles on how to move forward as an international community to address this financial crisis. Progress on this front is imperative to ensure the steps taken by one nation to improve oversight are not exploited by participants in the global financial community.

One global idea that should be seriously discussed is standardizing the sharing of international market data among regulators, which would allow authorities quicker access to market information from around the world in their policing of the financial system. Such a concept would be advanced by the agreement on a universal financial data format, such as the XML standard, and I strongly support this idea. Another global problem—witnessed firsthand by the futures industry in the crisis—is the difference in the bankruptcy treatment of customer assets around the world. In future cross-border discussions, regulators should also make it a priority to come up with common standards for this important customer protection issue.

In closing, it is clear that regulatory change is imminent. This industry can and should play a vital role in the coming regulatory revolution and do its part to restore confidence in the system. I think it would be a monumental mistake for this industry to put up roadblocks to reform and not engage in a constructive dialogue. If the U.S. futures industry wants to continue to lead the world, we must be fully engaged as thought leaders and strong advocates for a sensible path forward. Please do not misunderstand me. There will be countless bad ideas out there that would only make matters worse, and we should strongly resist ill informed initiatives. But in resisting bad ideas, we should strive to inform the debate with good alternatives and give testament to the experience of the futures industry over the last decade, in which volumes have quintupled while safety and soundness has been preserved and upheld. The first speech I gave as a Commissioner six years ago was at an FIA event here in Chicago on the benefits of "smart" regulation. Today I again ask this industry—in one of my final addresses on this Commission—to help policymakers find a "smart" regulatory solution for the betterment of the markets and the American public as a whole.

Thank you for allowing me to speak here today.